77-1724
No. 78-

IN THE

Supreme Court of the United States

October Term, 1977

HARRY G. BURKS, Jr., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

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June 2, 1978

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Citations

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Petitioners, Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey C. Hopkins,* S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips, Jeptha H. Wade, Anchor Corporation and Fundamental Investors, Inc., respectfully pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this proceeding on January 11, 1978.

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* Deceased.

Opinions Below

The opinions of the District Court (Hon. Henry F. Werker) are reported at 404 F. Supp. 1172 (S.D.N.Y. 1975) and at 426 F. Supp. 855 (S.D.N.Y. 1977). The District Court also filed an unreported opinion and order denying a motion for reargument on January 7, 1976. The opinion of the Court of Appeals is reported at 567 F.2d 1208 (2d Cir. 1978). All four opinions below are reproduced in the appendix to this petition.

Jurisdiction

The judgment of the Court of Appeals was entered on January 11, 1978, and a timely petition for rehearing was denied on March 9, 1978. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Question Presented

Plaintiffs*, two out of 90,000 shareholders of a mutual fund, seek to maintain a derivative action, purportedly on behalf of the fund, against the investment adviser and various directors of the fund for an investment loss sustained by the fund. The disinterested directors of the fund, who are not defendants in the lawsuit, exercising their business judgment and acting with the advice of independent special counsel, concluded that maintenance of the derivative action was contrary to the best interests of the fund and its shareholders, and instructed the fund's litigation counsel to move to dismiss the derivative action.

The District Court held, in its first opinion, that the disinterested directors had the power, as a matter of business judgment, to determine on behalf of the fund, not to prosecute the possible claim. After permitting extensive

* In this petition respondents are referred to as "plaintiffs" and petitioners as "defendants."

discovery on the issue of the independence of the disinterested directors, the District Court held, in its second opinion, that the disinterested directors were truly independent and had acted in good faith in making this determination. Accordingly, the District Court granted the motion to dismiss. The Court of Appeals, while agreeing that the disinterested directors had acted in good faith, held that the Investment Company Act of 1940 impliedly precluded the disinterested directors from exercising their business judgment to forego prosecution of the possible claim against the investment adviser and the other directors. On this basis, the Court of Appeals reversed and remanded the case.

Question: Are the independent and statutorily disinterested directors of a mutual fund incapacitated, *as a matter of law*, from exercising their business judgment to determine whether the maintenance of a stockholder's derivative action against the investment adviser and various directors of the fund for an investment loss is in the best interests of the fund and its shareholders: i.e., does the Investment Company Act of 1940 require that a stockholder's derivative action be permitted to proceed, in any and all events, even though the independent and statutorily disinterested directors have concluded, in the good faith exercise of their business judgment, that maintenance of the derivative action is contrary to the best interests of the fund and its shareholders?

Statutes Involved

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. §§ 80a-35(a), 35(b), (1970) and the Delaware General Corporation Law, 8 Del. Code §§ 141(a), 141(b) (1974).

Statement of the Case

This case arises out of the purchase in 1969 by Fundamental Investors, Inc. ("Fundamental"), a mutual fund,

of $20 million of the commercial paper of Penn Central Transportation Company ("Penn Central") from Goldman, Sachs & Co., a leading commercial paper dealer. At the time of the purchase, Penn Central commercial paper was rated "prime" (the highest rating) by the National Credit Office, a subsidiary of Dun & Bradstreet, Inc., the most widely utilized commercial paper rating agency in the country. Fundamental had a portfolio composed largely of equity securities and worth approximately $1 billion. The Penn Central commercial paper was purchased by Fundamental as a short-term investment of unemployed cash, i.e., a temporary utilization of funds until they were needed for purchases of equity securities in the stock market. Commercial paper of major national corporations has traditionally been considered by the financial community to be a cash equivalent.

On June 21, 1970, Penn Central, the sixth largest corporation in the country, filed a Petition for Reorganization, and the notes purchased by Fundamental (and many other financial institutions, universities, charitable organizations, etc.) were not paid at maturity.

On November 4, 1970, Fundamental initiated an action, with three other plaintiffs, against Goldman, Sachs & Co. ("the *Welch* action") under the federal securities laws for rescission of their purchases of the notes. The Complaint charged that Goldman, Sachs & Co., the exclusive dealer in Penn Central commercial paper, had withheld material, adverse non-public information on the financial condition of Penn Central.

On February 5, 1973, more than three years after the purchase by Fundamental, two stockholders of Fundamental commenced the instant derivative action ("the *Lasker* action") purportedly on behalf of Fundamental. The Complaint charged Anchor Corporation (the investment adviser to Fundamental) and all of the directors of Funda-

mental at the time of the purchase (i.e. 1969), with violations of statutory and common law duties in making and retaining the investment for Fundamental in Penn Central commercial paper.

On July 30, 1973, on motion of all defendants, and prior to joinder of issue, then District Judge Murray I. Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental against Goldman, Sachs & Co. in the *Welch* action.

On July 9, 1974, Fundamental settled the *Welch* action as follows: Goldman, Sachs & Co. took back the notes, paid Fundamental $5.25 million in cash and assigned to Fundamental a 73.75 per cent interest in the proceeds of the $20 million of notes in the Penn Central reorganization proceedings.

On July 24, 1974, at their next regular meeting, the Board of Directors of Fundamental reviewed the status of the *Lasker* action, and determined that the five directors who (a) were not affiliated in any way with the investment adviser (Anchor), and (b) were not directors at the time of the events complained of in the *Lasker* action, and (c) were not defendants in the *Lasker* action, would, acting as a quorum pursuant to the by-laws and Delaware law, constitute the Board of Directors to decide what position Fundamental should take regarding the *Lasker* action.* The

* Plaintiffs argued below that the five disinterested directors could not be independent because they had been nominated for their positions on the Board by defendants in the *Lasker* action. The District Court, after reviewing the extensive discovery on the issue of independence, held that there was no evidence whatsoever that any of the five disinterested directors was influenced in any way by any defendant in the *Lasker* action. See 426 F.Supp. at 846. The testimony clearly shows that no defendant ever mentioned the *Lasker* action to any one of the five directors prior to, at the time of, or in connection with, his or her nomination to the Board. Indeed, the first time that any of the five disinterested directors focused, at all, on the *Lasker* action was at the July 24, 1974 meeting when they were designated a quorum to decide what position should be taken by Fundamental—this meeting occurred several years after most of them became directors. Each of the five disinterested directors was a person of high repute and achievement in business or government, and each was selected by the Directors Qualification Committee which, at all times, consisted of a majority of disinterested directors.

six other directors, i.e. the four who were affiliated with Anchor and the two who were not affiliated with Anchor but who were named as defendants in the *Lasker* action, determined to take no part in the decision.

To assist them in their deliberations, the disinterested directors retained independent special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York. Judge Fuld had no previous connection with any of the parties.

On December 5, 1974, after several months of investigation, Judge Fuld reported the results of his analysis in a comprehensive legal and factual memorandum, and advised:

> "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provisions of statute or of any common law or contractual obligation to the fund, in connection with the acquisition and retention of the Penn Central commercial paper."

Judge Fuld also identified and analyzed the alternative courses of action available to the directors, and concluded his memorandum as follows:

> "It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt."

After receiving Judge Fuld's December 5, 1974 memorandum, the disinterested directors carefully reviewed it and raised several questions regarding the subjects covered in the memorandum and the alternatives available to them.

In response to these questions raised by the disinterested directors, on December 18, 1974, Judge Fuld delivered a brief supplemental memorandum in which he advised, among other things, that whether or not a corporation seeks to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management, and is left to the discretion of the directors.

On December 18, 1974, the disinterested directors held a special meeting devoted exclusively to this subject. At the meeting they discussed the entire matter with Judge Fuld at length, and questioned management about the details of the underlying transaction. After several hours of discussion, they adjourned the meeting and decided to give the matter further thought before reaching a decision.

On January 6, 1975, having conferred further with Judge Fuld in the interim, the disinterested directors held another special meeting of the Board. After several hours of review and deliberation, they voted unanimously to instruct the fund's litigation counsel to move to dismiss the *Lasker* action as contrary to the best interests of Fundamental. Their reasoning is set forth at length in the record and is quoted in the first opinion of the District Court.* (404 F. Supp. at 1176-77).

The District Court, in its first opinion, endorsed the basic theory of the motion to dismiss (i.e. that the disinterested directors had the power, in the exercise of their business judgment, to determine that the corporate claim asserted in the derivative action should not be prosecuted), but denied the motion with leave to renew following discovery on the sole issue of the independence of the

* Among the factors considered by the directors were the following: (a) Judge Fuld's opinion that Anchor had not violated any law or contractual obligation, (b) the directors' own determination that Anchor had acted in good faith in recommending the Penn Central investment, (c) the potential business disruption to Fundamental and its investment adviser if the action were to proceed, (d) the fact that numerous other respected institutional investors (including banks, hospitals, universities etc.) had made the same investment at the same time.

disinterested directors. The District Court wrote (404 F. Supp. at 1180):

> "If the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board."

At the conclusion of extensive discovery proceedings Fundamental renewed its motion to dismiss. The District Court granted the renewed motion and wrote (426 F. Supp. at 849):

> "Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently." [emphasis supplied].

On January 11, 1978, in an opinion devoid of supporting legal authority and contrary to all relevant precedents, the Court of Appeals reversed and remanded, concluding that, *as a matter of law*, the Investment Company Act of 1940 impliedly deprived the independent and statutorily disinterested directors of the fund of their power to determine *not* to assert a possible corporate claim against the investment adviser and other fund directors for an investment loss sustained by the fund.

A timely petition for rehearing *in banc* was denied on March 9, 1978.

Reasons for Granting the Writ

The decision of the Court of Appeals—holding that, *as a matter of law*, disinterested directors of a mutual fund, acting in good faith and with the advice of independent counsel, lack the power to exercise their business judgment to terminate a stockholder's derivative action against the investment adviser and various directors of the fund, maintenance of which the disinterested directors have concluded to be contrary to the best interests of the fund and its share-

holders—raises an important question involving the extent, if any, to which the Investment Company Act of 1940 displaces settled state law concerning corporate governance. This question has not been, but should be settled by this Court.* The decision of the Court of Appeals for the Second Circuit is in conflict with principles enunciated by this Court, is in conflict with applicable precedent in the Court of Appeals for the First Circuit (as well as its own prior precedents), and raises issues of substantial public importance.

The decision of the Court of Appeals, if allowed to stand, will undermine basic principles of corporate governance in the mutual fund industry.** Under this decision, mutual funds can be held hostage, in compulsory litigation, to the whims of a single stockholder. Such persons will be empowered to compel large public mutual funds, like Fundamental, to assert claims in litigation which disinterested directors, who are the legally elected representa-

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* The importance of the case was expressly recognized by the Court of Appeals in the opening sentence of its opinion:

> "*This appeal* by two mutual fund shareholders *raises an important question of first impression* . . ." [emphasis supplied]. (567 F.2d at 1208).

The importance of the case to the entire mutual fund industry, and to the rational utilization of the federal court system, is indicated by the *amicus* briefs filed in this case by Investors Diversified Services, Inc., the largest mutual fund complex in the country, and by the Investment Company Institute, the national association of mutual funds, investment advisers and underwriters.

** Although the Court of Appeals purported to confine its decision to the mutual fund industry, the central basis for its decision was a legal presumption that the independent directors could not pass fairly on plaintiffs' proposed corporate claims against the investment adviser and their fellow directors. See fn.*, p. 15 below and 567 F.2d at 1212. However, this presumption cannot readily be confined to mutual fund corporations—the pessimistic view of human nature which underlies the presumption applies, if at all, to all directors of all corporations, not just to directors of mutual fund corporations. Thus, if the opinion below is permitted to stand, it may well have a serious impact on corporate governance beyond the mutual fund industry.

tives of *all* stockholders, have determined to be contrary to the best interests of those mutual funds and their many shareholders.

The potentially harmful effects of the decision on mutual funds, their investment advisers and the federal courts are manifest. Invariably, some investments made by mutual funds will result in losses and others in profits. If the investment adviser and directors of mutual funds can be called to account in stockholder's derivative actions on every investment that results in a loss, without the disinterested directors being able to deflect such suits, where appropriate, in the exercise of their good faith business judgment, there would be unlimited potential for litigation which could cripple the mutual fund industry. Every investment decision (i.e. to buy, sell or hold) would become a potential subject for time consuming and expensive litigation in the federal courts; management of mutual funds would become an impossibly hazardous business, and the federal courts would be thrust into the role of arbiters of the propriety of every unsuccessful investment decision. Thus, the effects of the decision below are extraordinarily severe, since each fund makes literally thousands of investment decisions each year.

In short, this case raises the fundamental question of whether the legally elected representatives of *all* stockholders, or a single stockholder, who may well not have the broader interests of all stockholders in mind, will have the right to determine whether or not the mutual fund should assert a possible claim in litigation.

I.

The decision of the Court of Appeals in this case is in conflict with principles enunciated by this Court.

In a line of cases going back 75 years, this Court has held that the decision whether or not to prosecute litigation on behalf of a corporation rests solely with the board of directors. Absent fraud, corruption, or similar invalidating factors, the board's exercise of business judgment is final and a stockholder's derivative action does not lie. See, *e.g.*, *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903); *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917).

In *Corbus, supra,* this Court set forth the business judgment rule in the context of a litigation decision as follows:

> "The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation

to an act which their judgment does not approve, or to substitute his judgment for theirs." 187 U.S. at 463.

This doctrine was subsequently reaffirmed by this Court in *United Copper, supra.* In that case, the plaintiff stockholder claimed that his corporation had been damaged by the defendants' actions in violation of the anti-trust laws. The board considered suing the defendants and refused to do so. This Court ruled that the stockholder could not then maintain a derivative action on behalf of the corporation. Justice Brandeis wrote:

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders. 244 U.S. at 263.

The Court of Appeals in the case at bar legislated an exception to the business judgment rule inconsistent with the cases cited above and inconsistent with the structure of the Investment Company Act of 1940—the statute relied on by the Court of Appeals. If there is to be an exception to this rule, for mutual funds, that exception should be legislated by Congress and not by the courts. Neither the provisions of the Investment Company Act of 1940 nor the legislative history suggests that Congress ever intended any such exception.*

* Indeed, the legislative history, which was not cited by the Court of Appeals, contradicts the result reached by the Court of Appeals in this case. See Point IV below.

II.

The decision of the Court of Appeals in this case is in conflict with applicable and controlling state law of corporate governance and the pronouncements of this Court on the deference to be given state law in such matters.

This Court has specifically held that in the absence of any *express* federal statutory provision to the contrary, state law governs the powers of directors. Thus, in *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462, 479 (1977), this Court last year wrote:

> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." [quoting from *Cort* v. *Ash,* 422 U.S. 78, 84 (1975)] [emphasis in original].

Fundamental, the mutual fund involved in this case, is a Delaware corporation.* Delaware General Corporation Law, Section 141(a), empowers the board of directors of a corporation to manage the affairs of the corporation. No distinction is made under that law for mutual fund corporations. Management of the affairs of a corporation has long been held to include the power to decide whether or not to pursue a possible claim of the corporation in litigation. The District Court so held at bar, and the Court of Appeals did not take issue with this principle.

The Court of Appeals, however, erroneously differentiated between mutual fund directors and directors of

* Congress, when it enacted the Investment Company Act of 1940, left the organization of mutual funds to state law. Mutual funds are creatures of state law, not (like national banks, for example) creatures of federal law.

other types of business corporations with respect to their business judgment power to maintain or not maintain litigation on behalf of the corporation.* In so doing, the Court of Appeals engrafted onto the Investment Company Act of 1940 new limitations on the powers of mutual fund directors *not* placed there by Congress and in conflict with the plan of corporate governance intended by the law of Delaware.

The Court of Appeals did not and could not cite any provision of federal law which *expressly* overrides or abrogates the power of the directors under state law. The fact is that there is no such provision in the Investment Company Act of 1940 or in any other federal statute. Thus, the decision of the Court of Appeals is in conflict with the principles clearly enunciated by this Court in *Santa Fe* and *Cort, supra.* The Court of Appeals simply created a rule of federal law where none exists. In this case, the Delaware law must be given effect since there is no federal law *expressly* (or, as shown in Point IV, impliedly) overriding Delaware law.

III.

The decision of the Court of Appeals for the Second Circuit in this case is in conflict with the decision of the Court of Appeals for the First Circuit in *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973).

The Court of Appeals in this case singled out mutual fund directors and, without warrant, distinguished them

* The Court of Appeals also erroneously stressed the fact that the decision at bar was reached by a "minority" of the board, disregarding the fact that the "minority" of five disinterested directors indisputably constituted a lawful quorum under Delaware General Corporation Law Section 141(b) and under Fundamental's certificate of incorporation.

from directors of all other types of corporations. Thus, the Court of Appeals wrote (567 F.2d at 1212 n.14):

> "We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of a similar power by directors of other types of corporations."*

The notion that mutual fund directors—especially the disinterested directors—are under a special disability vis-a-vis directors of other types of corporations in exercising business judgment concerning the maintenance of litigation, has been firmly rejected by the Court of Appeals for the First Circuit in the leading case of *In re Kauffman Mutual Fund Actions,* 479 F. 2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), a case not even cited by the Court of Appeals below.** The Court of Appeals for the First Circuit there wrote (479 F.2d at 266-267):

> ". . . the underlying business judgment may be sufficiently unsound to call for correction. But it does not follow that it is to be conclusively presumed in such a case that an unaffiliated, or disinterested director, if demand were made upon him, would be

* As noted above at p. 9, this attempt by the Court of Appeals to limit the scope of its ruling is illusory. The central basis for the decision of the Court of Appeals was the legal presumption that, because the independent directors had to work and interact with their fellow directors, "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." 567 F.2d at 1212. How the "unique nature" of the mutual fund industry supports application of such a presumption is not explained, nor can it be. In any event, application of such a presumption in the context of mutual funds conflicts with settled law in another circuit, as shown in Point III.

** The result reached by the Court of Appeals at bar also renders meaningless Rule 23.1 Fed. R. Civ. P. Why have a rule requiring demand on directors if the directors have no power to act?

unable to exercise an independent judgment in considering what new course to take." [footnote and citation omitted].

"Nor do we think that an exception is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. Normally self-dealing by any corporate directors is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. *In order to make sure that the directorate not be top-heavy, it [Congress] provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from a disinterested director in any other corporate venture.* All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' [citation omitted]. When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim, [citation omitted], *it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure'* [i.e., the disinterested

directors] *to decide on the appropriate corporate response.* [citation omitted]. *To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it.*" [emphasis supplied].

At bar, under the *per se* rule of disqualification adopted by the Court of Appeals, the disinterested directors were improperly deprived of their opportunity to serve as "watchdogs" of the fund's best interests because they were presumed to be legally incapable of deciding on the appropriate corporate response.

IV.

The reasoning of the Court of Appeals, insofar as it purports to find a basis for its holding in the Investment Company Act of 1940, does not withstand analysis.*

This action is brought under Section 36(a) of the Investment Company Act of 1940. The Court of Appeals

* The decision below also conflicts with two earlier decisions by the Court of Appeals for the Second Circuit under the Investment Company Act of 1940: *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 and *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir. 1977). In *Fogel supra*, Judge Friendly wrote (553 F.2d at 749-50):

"Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation or recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.

"If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case."

erroneously equated Section 36(a) of the Investment Company Act of 1940 with Section 36(b).* The Court of Appeals reasoned that since Congress, in the 1970 amendments to the Investment Company Act of 1940, "specifically provided in Section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser," it "would surely be anomalous" not to imply the same power for the alleged violations of Section 36(a) of the Investment Company Act of 1940 sued upon here. (567 F.2d at 1212). Why it "would surely be anomalous" is not explained, nor is any authority offered for the proposition.

Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act of 1940 —it is a unique and highly specific section dealing solely with the compensation of investment advisers. Section 36(b) *expressly* created a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees, irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.

If Congress had intended to provide in Section 36(a), a far broader section than Section 36(b), the unique mechanisms of Section 36(b), it could and would have done so in the 1970 amendments—it did not do so. The Court of Appeals improperly added such a provision to Section 36(a) where Congress saw fit not to do so.

The legislative history, which was not cited by the Court of Appeals, supports defendants' view. Thus, Senate Report No. 91-184, which accompanied the 1970 amendments, states:

> "Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), *the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a).*" [emphasis supplied]. 3 U.S. Code Cong. & Ad News, 91st Congress, at p. 4911 (1970).

* Section 36(a) deals with breaches of fiduciary duty; Section 36(b) deals solely with compensation of investment advisers.

The foregoing passage, although focusing on the existence of a private right of action, a subject not at issue in this case, indicates that Congress did not intend that the new Section 36(b) be read to affect, in any way, Section 36(a), i.e., old Section 36. In short, the subject of investment adviser compensation, covered by Section 36(b), is *sui generis.*

Moreover, the Report expressly reaffirmed Congress' intent not to disturb the authority of disinterested directors to manage the affairs of a mutual fund in the exercise of their business judgment, consistent with settled state law concerning corporate governance:

> "These provisions highlight the fact that *the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of the directors.* Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation. *The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.*" [Emphasis supplied] *Id.*, at p. 4903.

A fortiori, if Congress in Section 36(b), which contains an express right of action, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary, it necessarily follows that Congress, in Section 36(a), where there is no such express right, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary.

At bar, the District Court correctly analyzed and rejected the plaintiffs' argument based on the public policy of the Investment Company Act of 1940 and held (404 F.Supp. at 1179-80):

> "This Court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. [Citations omitted]. It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final."

On a motion by plaintiffs for reargument, the District Court specifically addressed and rejected the Section 36(b) argument, and held, in an unreported opinion and order (see appendix):

> "That section [36(b)] specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under section 36(a) . . . where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim."

The District Court correctly perceived the distinction between Sections 36(a) and 36(b); the Court of Appeals either misperceived or ignored the distinction.

* * *

In sum, in this case the disinterested directors of the mutual fund, after the fund had received a substantial settlement of its investment loss, and based on the advice of eminent, independent counsel, made a good faith determination, in the exercise of their business judgment, that maintenance of this derivative action was contrary to the best interests of the fund and its shareholders. In so doing the directors exercised managerial power granted under state law. The Court of Appeals concluded that such state law power could not be exercised because of a supposed congressional intent. However, that intent is nowhere expressed in the Investment Company Act of 1940 and is in fact negated by the legislative history of the Investment Company Act of 1940.

The decision below does violence to prior decisions of this Court and conflicts with a decision in another circuit. It presents an important question of federal law which should be decided by this Court concerning the construction of the Investment Company Act of 1940 and the deference to be given by federal courts to state law powers concerning corporate management.

CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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June 2, 1978

APPENDIX

Opinion of the District Court, September 24, 1975

States v. Bettenhausen, 499 F.2d 1223 (CA10 1974). As stated in *United States v. Fancutt*, 491 F.2d 312, 314 (CA 10 1954):

> "Jury verdicts in criminal cases are to be rendered on the facts as disclosed by evidence and the law as pronounced by the court. That which the prosecutor thinks, believes or knows are not to be given consideration. Such argument is improper."

The issue in this type of proceeding, however, is not whether the actions of the district attorney were error but whether the conviction of the petitioner was the result of an unfair trial in violation of the Fourteenth Amendment. *Sampsell v. People of the State of California*, 191 F.2d 721 (CA9 1951). It is only where criminal trials in state courts are conducted in such a manner as amounts to a disregard of that fundamental fairness essential to the very concept of justice that due process is offended and federal court interference is warranted. *Chavez v. Dickson*, 280 F.2d 727 (CA9 1960). After careful consideration of the record, it cannot be said that the efforts of the prosecutor resulted in a denial of the fundamental fairness essential to the concept of justice. As pointed out in *United States v. Fay*, 350 F.2d 400, 401 (CA2 1965):

> "[For] whatever error the state court may have committed in failing to grant a new trial, the defect in the trial did not attain constitutional proportions. The prosecutor's conduct did not create a situation so prejudicial to the appellant that he was denied a fair trial within the meaning of the due process clause of the Fourteenth Amendment.
>
> . . . .
>
> "Conduct of state prosecutors which it was contended was unfair and prejudicial has consistently been held on collateral attack in the federal courts to fall short of constituting a lack of due process. [Citations omitted.]"

This is not a case where the comment of the prosecutor infringed upon any specific guarantees of the Bill of Rights. It is not a case where the prosecutor consistently and repeatedly misrepresented the evidence before the jury. Cf. *Miller v. Pate*, 386 U.S. 1, 87 S.Ct. 785, 17 L.Ed.2d 690 (1967). It is not a case where there was non-disclosure by the prosecution of specific evidence favorable to the accused. Cf. *Brady v. Maryland*, 373 U.S. 83, 83 S.Ct. 1194, 10 L.Ed.2d 215 (1963). There was otherwise no unfair manipulation of the evidence so as to have an effect on the jury's determination. The evidence of guilt was strong. In fact, the petitioner admitted guilt but relied upon the defense of entrapment. The actions of the prosecutor constituted only the ordinary trial errors of a prosecutor, not that sort of flagrant misconduct necessary to establish a denial of constitutional due process for relief on collateral attack. See *Donnelly v. De Christoforo*, 416 U.S. 637, 94 S.Ct. 1868, 40 L.Ed.2d 431 (1974).

Accordingly for the foregoing reasons the Petition for Writ of Habeas Corpus will be denied.

It is so ordered.

Howard M. LASKER and Irving Goldberg, Plaintiffs,

v.

Harry G. BURKS, Jr., et al., Defendants.

No. 73 Civ. 552 (HFW.)

United States District Court, S. D. New York.

Sept. 24, 1975.

As Amended Oct. 17, 1975.

Two stockholders of registered investment company brought shareholders' derivative action against company's in-

vestment advisor and several former and present members of the company's board of directors. On the company's motion to dismiss, the District Court, Werker, J., held that an independent minority of the company's board of directors, who constituted a quorum, had the power to decide what position the company should take in the suit; that the strong public policies behind the Investment Company Act and the Investment Advisers Act did not bar the board of directors from exercising its business judgment on the suit; that the board's decision not to sue was not tantamount to an illegal ratification; and that a question of fact existed as to whether the minority directors were truly disinterested and independent.

Motion denied without prejudice.

1. Corporations ⟹310(1)

In stockholders' derivative suit against, inter alia, several company directors, disinterested directors, who were minority of board, constituted quorum, and were designated by full board to make decision as to company's position in the suit, had power to exercise their business judgment as to what position company should take. Fed.Rules Civ. Proc. rule 23.1, 28 U.S.C.A.

2. Corporations ⟹310(1)

Absent fraud or corruption or other factors, stockholders cannot force corporation to sue. Fed.Rules Civ.Proc. rule 23.1, 28 U.S.C.A.

3. Corporations ⟹310(1)

Strong public policies behind Investment Company Act and Investment Advisers Act did not deprive corporate board of directors of its power to exercise business judgment over stockholders' derivative action. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.; Investment Advisers Act of 1940, § 201 et seq., 15 U.S.C.A. § 80b-1 et seq.; Fed.Rules Civ.Proc. rule 23.1, 28 U.S.C.A.

4. Securities Regulation ⟹218, 223

Causes of action under Investment Company Act and Investment Advisers Act are implied rights of action. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.; Investment Advisers Act of 1940, § 201 et seq., 15 U.S.C.A. § 80b-1 et seq.

5. Corporations ⟹310(1)

Board of directors' decision to oppose stockholders' derivative suit in exercise of its business judgment did not amount to illegal ratification. Fed.Rules Civ.Proc. rule 23.1, 28 U.S.C.A.

6. Federal Civil Procedure ⟹1741

In investment company's stockholders' derivative action against company's investment adviser and several former and present members of company's board of directors, question of fact existed as to whether minority directors were truly disinterested or independent, precluding granting motion to dismiss on ground that disinterested minority of board of directors had determined that, in their business judgment, action was contrary to best interests of company shareholders. Fed.Rules Civ.Proc. rules 12(b), 23.1, 28 U.S.C.A.

Aranow, Brodsky, Bohlinger, Benetar & Einhorn, New York City, for plaintiffs.

Dewey, Ballantine, Bushby, Palmer & Wood, New York City, for defendants Burks, Hopkins, Kemmerer, Monroney, Phillips & Wade.

Seward & Kissel, New York City, for defendant Fundamental Investors, Inc.

Pollack & Singer, New York City, for defendants Burr, Chalker, Hutchinson, Haire & Anchor Corp.

MEMORANDUM DECISION AND ORDER

WERKER, District Judge.

This is a shareholders' derivative action brought by two stockholders on behalf of Fundamental Investors, Inc.

("Fundamental" or the "Fund"), a registered investment company under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* The defendants are the Fund's investment adviser, Anchor Corporation ("Anchor"), a registered investment adviser under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*, and several former and present members of the Board of Directors of the Fund. The dispute between the parties centers around the Fund's purchase, on Anchor's recommendation, of $20 million in commercial paper of the now bankrupt Penn Central Transportation Company. As described in detail below the complaint charges that in connection with the purchase of the Penn Central paper the defendants violated various sections of the Investment Company Act, the Investment Advisors Act and the common law. The Fund, joined by all defendants, has now moved under Rule 12(b) of the Federal Rules of Civil Procedure to dismiss this action on the ground that the independent members of the Board of Directors of the Fund have unanimously determined that, in their business judgment, this action is contrary to the best interests of the shareholders of the Fund.

BACKGROUND

The Fund made its purchases of Penn Central 270-day notes from Goldman, Sachs & Co., in lots of $5 million each on November 26, December 2, 4 and 8, 1969. Unfortunately for the Fund and other holders of Penn Central commercial paper, Penn Central, on June 21, 1970, filed a petition for reorganization under section 77 of the Bankruptcy Act with the result that the notes were not paid at maturity or at any time to date. Faced with the possibility of a substantial loss, the Fund and other plaintiffs instituted suit in the Southern District of New York on November 4, 1970 against Goldman, Sachs & Co., for rescission of their purchases of the Penn Central Notes. That action was entitled *Welch Foods, Inc. v. Goldman, Sachs & Co.*, D.C., 398 F.Supp. 1393 (the "*Welch*" action).

The instant derivative suit was filed on February 5, 1973. Jurisdiction was predicated on section 44 of the Investment Company Act of 1940 (15 U.S.C. § 80a-43), section 214 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-14) and pendent jurisdiction. The complaint alleges that in making the purchases of Penn Central commercial paper the Fund and Anchor relied solely and exclusively on Goldman, Sachs & Co., and made no independent investigation of the financial condition of Penn Central or the quality of its commercial paper. By failing to make an independent investigation it is alleged that Anchor failed to meet its responsibility as the Fund's investment adviser and that the Fund's directors knew or should have known of, and acquiesced in, the failure of Anchor to meet its responsibilities and thus failed to meet their responsibilities as members of the Fund's Board of Directors. Had an independent investigation been made it is alleged that a number of material adverse facts concerning the financial condition of the Penn Central and the quality of its commercial paper would have been learned. As a result of their actions, or inactions, the defendants are charged with engaging in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund in violation of section 36 of the Investment Company Act. Anchor is also alleged to have violated section 206, the antifraud section of the Investment Advisors Act of 1940. Plaintiffs also claim that the defendants violated their common law fiduciary duty to the Fund and that Anchor, aided and abetted by the directors, breached its investment advisory contract with the Fund.

The complaint goes on to allege that from November 28, 1969 to June 21, 1970, the date Penn Central filed for reorganization, the financial condition of the Penn Central deteriorated. During this period it is alleged that Anchor and the Fund directors failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn

Central and the quality and safety of its commercial papers. It is also alleged that during this period the Fund's directors failed in their obligations to make adequate attempts to resell the Penn Central commercial paper it held and that Anchor failed to advise the Fund of the advisability of selling the commercial paper. Plaintiffs again claim that these acts by the defendants violate section 36 of the Investment Company Act; that Anchor violated section 206 of the Investment Advisers Act; that all defendants breached their common law fiduciary duty; and that Anchor, aided and abetted, by the Fund's directors breached its investment advisory contract. Finally, the complaint alleges that the defendants violated section 13 (a)(3) of the Investment Company Act by allowing the Fund to hold more than 10% of the securities of any one issuer (Penn Central) in contravention of the Fund's registration statement filed pursuant to section 8(b) of the Investment Company Act.

Subsequent to the filing of this derivative action, all defendants moved to stay this action pending the resolution of the claims of Fundamental in the *Welch* action. The stay was granted by Judge Gurfein on November 12, 1973. Fundamental's claims against Goldman, Sachs & Co., in the *Welch* action were settled on July 9, 1974. The terms of the settlement provided that Goldman, Sachs & Co. would take back the Penn Central notes, pay Fundamental $5,250,000.00 in cash and assign to Fundamental a 73.75% interest in the proceeds of the notes in the reorganization proceedings.

With the settlement of the *Welch* action, Fundamental had to determine what position to take in this suit. It is necessary to set forth in detail the actions taken by the Fund's Board of Directors since it forms the basis of the defendants' motion to dismiss.

Fundamental's Board of Directors met on July 24, 1974 to review the settlement of the *Welch* action and to decide what position to take in this derivative action. Since five of the directors are defendants in this action and one is a director of Anchor, the Board determined that the remaining five directors who they considered disinterested would, acting as a quorum pursuant to the bylaws,[1] decide what position the Fund should take in this action. The five disinterested directors then decided to retain the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the entire Penn Central matter and to report to the Board.

After reviewing the complaint in this derivative action, the proceedings in the *Welch* action, the files of Anchor and the Fund relating to the purchase of Penn Central paper and after interviewing officers and employees of the Fund and analyzing the facts and the law, Judge Fuld sent a memorandum to the disinterested directors on December 5, 1974 in which he stated his opinion that there was "no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial

1. Section 1 of Article Eight of the Certificate of Incorporation of Fundamental provides that:

"The number of directors which shall constitute the whole board of directors shall be such as from time to time shall be fixed by or in the manner provided in the by-laws which shall also provide the number of directors which shall constitute a quorum; provided, that in no case shall a quorum be less than one-third of the total number of directors nor less than two directors."

Section 4 of Article Six of the By-Laws of Fundamental provides that:

"*Quorum:* Except as otherwise provided by law, the Certificate of Incorporation, or these By-Laws, at all meetings of the Board of Directors one-third of the directors then in office, but not less than three directors shall be necessary for the transaction of business."

paper." (Dec. 5, 1974 Memorandum at 2). Judge Fuld went on to discuss in detail each of the claims asserted in this suit. Finally, Judge Fuld defined and discussed three alternative courses of action which the disinterested directors might pursue, *i. e.*, (1) seek realignment so as to become a plaintiff for the purpose of exercising control over and prosecuting the action; (2) conclude that the action is sufficiently lacking in merit and move to have the suit dismissed; and (3) take a neutral position and permit the action to proceed for the Fund's benefit under the auspices of the present plaintiffs.

After the disinterested directors reviewed his report and submitted questions to him, Judge Fuld sent a supplemental memorandum to the disinterested directors on December 18, 1974. In his memorandum Judge Fuld discussed in more detail the possibility that the Board should move to dismiss this suit as not being in the best interests of the Fund and the possible scope of judicial review of such a decision.

The disinterested directors then met in a series of special meetings to consider Judge Fuld's memoranda. The directors met with Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, unaffiliated directors of Fundamental; and Eugene Souther, litigation counsel to Fundamental in this action. Questions were posed by the directors to all of these in attendance concerning the merits of the derivative action and the alternatives open to the Fund's Board. The disinterested directors again met in private and decided to give additional consideration to the problem and convey any questions to the designated Chairman of the disinterested directors, Leon T. Kendall.

A second special meeting of the disinterested directors was held on January 6, 1975. Upon review of the alternatives available, the directors present unanimously determined[2] that the prosecution of this action was contrary to the best interests of the shareholders of Fundamental and that counsel should be directed to seek dismissal of the action. The factors considered by the directors in reaching their conclusion are summarized in the Kendall affidavit ¶ 22, and are as follows:

"(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;

(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally

2. One director, Mary S. O'Connor, was not present at the meeting. She had previously told Mr. Kendall what her decision was. That vote was reaffirmed by Mrs. O'Conner at a special meeting of the disinterested directors held on January 22, 1975. Even without her presence, four directors would constitute a quorum.

held belief that commercial paper was equivalent to cash;

(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analysed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be liable to Fundamental; and

(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

DISCUSSION

The Fund now argues that the extensive consideration given to the alternatives available to the independent directors culminating in their decision to seek dismissal of this suit was a good faith exercise of business judgment which cannot be upset by the two shareholder plaintiffs who would force Fundamental to maintain this action. The plaintiffs, of course, dispute this position. After emphasizing, the merits of the claims they have asserted and criticizing the conclusions reached by Judge Fuld, plaintiffs make the following arguments in opposition to the defendants' motion to dismiss: (1) because of the broad regulatory legislation embodied in the Investment Company and Investment Advisers Act, the decision whether to prosecute violations of that Act is not a matter of "business judgment" to be decided by directors of a regulated fund; (2) to seek dismissal of the action would be tantamount to an unlawful ratification of defendants' conduct; (3) if a majority of the board's directors are disqualified, the existence of a "disinterested" minority is irrelevant; (4) as a matter of law the minority directors are not "disinterested;" (5) the minority directors gave undue deference to Anchor in making their decisions; and (6) the motion is premature and defective under Rule 23.1. These arguments will now be considered.

At the outset, the obvious should be stated—a shareholder's derivative suit is an action brought on behalf of a corporation in which any recovery runs in favor of the corporation. Ordinarily, it is the corporation which would seek the right to enforce any cause of action it might have. Rule 23.1 of the Federal Rules of Civil Procedure requires that a complaining shareholder demand action from the board of directors before

bringing suit.[3] The purpose of that "demand" rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." *Brody v. Chemical Bank*, 517 F.2d 932 at 934 (2 Cir. 1957), citing *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973).

No demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are defendants charged with wrongdoing and as such a demand would be futile.[4] While no set formula has been developed for determining what facts must be plead in order to excuse a demand on the Board of Directors—*see generally*, 7A Wright & Miller Federal Practice & Procedure § 1831 (1972)—that issue is not presented in this case. Instead, this case presents the rather unique situation where a designated independent minority of a Board has taken unilateral action with respect to a suit brought on behalf of the corporation. The decision of the independent directors was made after the settlement of the *Welch* action which put an end to the stay in this suit. Plaintiffs argue that even if suit were instituted at the present time (*i. e.*, after settlement of the *Welch* action) no prior demand on the Fund's Board would have been necessary because the majority of directors would be disqualified. To allow a minority of the Board to seek dismissal of the suit would, it is argued, destroy the role of "presumptive disqualification."

While no case is directly in point, this circuit has recently considered an analogous issue in *Brody v. Chemical Bank, supra*. There, the district court had dismissed the derivative causes of action in plaintiff's complaint because the allegations in the complaint were insufficient to excuse a demand on the Board of Directors. Plaintiff had alleged futility of demand because the majority of directors were controlled by the defendant corporation. However, since institution of the suit, a new Board had been installed but no demand was made on it. The Second Circuit agreed that a demand should have been made but remanded because of the gravity of the alleged wrongdoing. 482 F.2d 1111 at 1114 (2 Cir.). After remand, the plaintiffs filed a second amended complaint but made no demand on the Board of Directors because they alleged that a demand on the Board of Directors at the time the action was originally com-

3. Rule 23.1 provides:

"In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

4. No issue has been raised concerning whether a demand on the shareholders was necessary. Plaintiffs' complaint alleges that under applicable law and the Certificate of Incorporation and By-Laws of the Fund, the directors and officers are vested with the management of the Fund. Complaint ¶ 7(b).

menced would have been futile. The district court again dismissed the derivative counts and the Second Circuit affirmed on the reasoning that a demand should have been made on the new directors. *Brody, supra* at 934.

[1] In this case, within a short period after settlement of the *Welch* action and the dissolution of the stay, the Board of Directors met and designated the independent directors to make a decision as to the Fund's position in this suit. In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. *See* 3B J. Moore, Federal Practice ¶ 23.1.19, at 23.1–252–53 (2d ed. 1974) quoted in *Brody, supra* at 934.

Although the independent directors could properly move for dismissal of this action it is now necessary to determine whether good faith business judgment of the directors can be used as a ground for dismissal. Defendants rely on a line of cases which hold that absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final. *See, e. g., Hawes v. Oakland,* 104 U.S. 450, 26 L.Ed. 827 (1881); *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256 (1903); *United Copper Securities Co. v. Amalgamated Copper Co.,* 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Swanson v. Traer,* 249 F.2d 854 (7th Cir. 1957); *Ash v. IBM,* 353 F.2d 491 (3d Cir. 1965), *cert. denied,* 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). *Cf. Allegheny Corp. v. Kirby,* 344 F.2d 571 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28, 86 S.Ct. 1250, 16 L.Ed.2d 335 (1966).

[2] As the Supreme Court recognized in *United Copper, supra,* the decision whether or not to sue is a matter of internal management. 244 U.S. at 263, 37 S.Ct. 509. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue.

> "[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers . . . This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies . . . where the mistake alleged is the refusal to assert a seemingly clear cause of action . . . ."

Ashwander v. Valley Authority, 297 U. S. 288, 343, 56 S.Ct. 466, 481, 80 L.Ed. 688 (1936).

The reasoning behind the "business judgment rule" and its application to derivative suits was recently discussed in this district in *Bernstein v. Mediobanca,* Docket #73 Civ. 3549, (S.D.N.Y. Dec. 24, 1974) (Connor, J.). There the Court reaffirmed the business judgment rule although summary judgment was denied, with leave to renew, because possible evidence of bad faith on the part of the Board of Directors in deciding not to sue was in the possession of the defendants and plaintiff was given an opportunity to discover it.

[3, 4] This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. *Brown v. Bullock,* 194 F.Supp. 207 (S.D.N.Y., *aff'd* 204 F.2d 415 (2d

bringing suit.[3] The purpose of that "demand" rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." *Brody v. Chemical Bank,* 517 F.2d 932 at 934 (2 Cir. 1957), citing *In re Kauffman Mutual Fund Actions,* 479 F.2d 257, 263 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973).

No demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are defendants charged with wrongdoing and as such a demand would be futile.[4] While no set formula has been developed for determining what facts must be plead in order to excuse a demand on the Board of Directors—*see generally,* 7A Wright & Miller Federal Practice & Procedure § 1831 (1972)—that issue is not presented in this case. Instead, this case presents the rather unique situation where a designated independent minority of a Board has taken unilateral action with respect to a suit brought on behalf of the corporation. The decision of the independent directors was made after the settlement of the *Welch* action which put an end to the stay in this suit. Plaintiffs argue that even if suit were instituted at the present time (*i. e.,* after settlement of the *Welch* action) no prior demand on the Fund's Board would have been necessary because the majority of directors would be disqualified. To allow a minority of the Board to seek dismissal of the suit would, it is argued, destroy the role of "presumptive disqualification."

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4. No issue has been raised concerning whether a demand on the shareholders was necessary. Plaintiffs' complaint alleges that under applicable law and the Certificate of Incorporation and By-Laws of the Fund, the directors and officers are vested with the management of the Fund. Complaint ¶ 7(b).

menced would have been futile. The district court again dismissed the derivative counts and the Second Circuit affirmed on the reasoning that a demand should have been made on the new directors. *Brody, supra* at 934.

[1] In this case, within a short period after settlement of the *Welch* action and the dissolution of the stay, the Board of Directors met and designated the independent directors to make a decision as to the Fund's position in this suit. In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. *See* 3B J. Moore, Federal Practice ¶ 23.1.19, at 23.1-252-53 (2d ed. 1974) quoted in *Brody, supra* at 934.

Although the independent directors could properly move for dismissal of this action it is now necessary to determine whether good faith business judgment of the directors can be used as a ground for dismissal. Defendants rely on a line of cases which hold that absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final. *See, e. g., Hawes v. Oakland,* 104 U.S. 450, 26 L.Ed. 827 (1881); *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256 (1903); *United Copper Securities Co. v. Amalgamated Copper Co.,* 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Swanson v. Traer,* 249 F.2d 854 (7th Cir. 1957); *Ash v. IBM,* 353 F.2d 491 (3d Cir. 1965), *cert. denied,* 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). *Cf. Allegheny Corp. v. Kirby,* 344 F.2d 571 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28, 86 S.Ct. 1250, 16 L.Ed.2d 335 (1966).

[2] As the Supreme Court recognized in *United Copper, supra,* the decision whether or not to sue is a matter of internal management. 244 U.S. at 263, 37 S.Ct. 509. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue.

> "[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers . . . This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies . . . where the mistake alleged is the refusal to assert a seemingly clear cause of action . . . ."

Ashwander v. Valley Authority, 297 U.S. 288, 343, 56 S.Ct. 466, 481, 80 L.Ed. 688 (1936).

The reasoning behind the "business judgment rule" and its application to derivative suits was recently discussed in this district in *Bernstein v. Mediobanca,* Docket #73 Civ. 3549, (S.D.N.Y. Dec. 24, 1974) (Connor, J.). There the Court reaffirmed the business judgment rule although summary judgment was denied, with leave to renew, because possible evidence of bad faith on the part of the Board of Directors in deciding not to sue was in the possession of the defendants and plaintiff was given an opportunity to discover it.

[3, 4] This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. *Brown v. Bullock,* 194 F.Supp. 207 (S.D.N.Y., *aff'd* 204 F.2d 415 (2d

Cir. 1961); *Bolger v. Laventhol, Krekstein, Horwath & Horwath,* 381 F.Supp. 260 (S.D.N.Y.1974). It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is "implied" the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final.

[5] The court must also reject plaintiffs' argument that the decision not to sue was tantamount to an illegal ratification. Although it can be argued that derivative suits should be allowed when the Board has refused to sue on a nonratifiable wrong—*see* Note, Demand on Directors and Shareholders as a Prerequisite To a Derivative Suit, 73 Harv. L.Rev. 746, 762 (1960); *Rogers v. American Can Co.,* 305 F.2d 297 (3d Cir. 1962), the question of business judgment is separate from the question of ratification. *S. Solomont & Sons Trust v. New England Theatres Operating Corp.,* 326 Mass. 99, 93 N.E.2d 241, 247 (1950). Many of the cases which established the business judgment rule and its relation to derivative suits have involved claims which were arguably non-ratifiable. *See, e. g., United Copper, supra; Ash v. IBM, supra* (antitrust violations).

[6] Another question which has been considered is whether the merits of the plaintiffs' claim should be considered in deciding whether the directors decision should be upheld. To do so would place the Court in the position of substituting its judgment for that of the directors which if made in good faith should not be disturbed. The court has carefully reviewed the many factors which the Board considered before making its decision not to sue. Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, there were many other factors considered by the directors, as outlined in the Kendall Affidavit ¶ 22—which led the directors to their decision.

If the minority directors were truly disinterested and independent the court will not substitute its judgment for that of the Board. Plaintiffs have not argued that the minority directors have acted fraudulently or corruptly. They have argued that they are not disinterested or independent because they occupy similar positions with other funds in the Anchor group and that Anchor controls the selection and nomination of the Fund's directors. This assertion has been denied and it is alleged by the movant that these directors were nominated by a three man Directors Qualification Committee of which two members were unaffiliated with Anchor.

Interest or lack of independence would go toward the issue of good faith. I am constrained therefore to permit the plaintiffs to pursue discovery with respect to the relationships of the minority directors and the Qualifications Committee to determine whether the minority directors were disinterested or independent. It would appear that all of the other questions resolved herein are dependent upon a resolution of this issue. The plaintiffs are to conduct their discovery within 90 days from the date hereof.

The motion is denied without prejudice to renew the same upon the completion of discovery.

So ordered.

Opinion of the District Court, January 6, 1976

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

-----------------------------x

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs,

- against -

HARRY G. BURKS, JR.,
EDWARD B. BURR,
THOMAS F. CHALKER,
JOHN R. HAIRE,
HARVEY C. HOPKINS,
S. P. HUTCHINSON,
DONALD L. KEMMERER,
A. S. MIKE MONRONEY,
CHARLES F. PHILLIPS,
JEPTHA WADE,
ANCHOR CORP., and
FUNDAMENTAL INVESTORS, INC.,

Defendants.

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ORDER

73 Civ. 552 (HFW)

HENRY F. WERKER, D. J.

Plaintiffs' motion for reargument based on Judge Gagliardi's decision in Boyko v. The Reserve Fund, Inc., 74 Civ. 3419 (S. D. N. Y. Sept. 31, 1975) is denied. This court finds that Boyko is distinguishable from the case at hand due to the fact that Boyko concerns Section 36(b) of the Investment Company Act, 15 U.S.C. § 80a-35(b). That section specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under Section 36(a), 15 U.S.C. § 80a-35(a), where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the

statute to a security holder on such a claim.

SO ORDERED.

DATED: New York, New York

January 6, 1976

Henry F. Werker

U. S. D. J.

Opinion of the District Court, January 7, 1977

torney had represented to the court, or, if he did consent, lacked authority to do so. In effect, the Vorhauers seek to recover *against the United States* either for (1) the misrepresentations of an assistant United States Attorney, (2) the presumably unjustified reliance by an assistant United States Attorney on the authority of Mr. Scandone to consent to the destruction of plaintiffs' property, or (3) the presumably unjustified reliance by a District Judge on the representations of an assistant United States Attorney. Even if the plaintiffs were able to prove that the actions of the Assistant United States Attorney or Chief Judge Lord were in some way culpable[5] they would not be able to recover against the United States because these actions were certainly not authorized by it. See *Regional Rail Reorganization Act Cases*, supra, 419 U.S. at 127, 95 S.Ct. at 350 n. 16; *Yearsley v. Ross Construction Co.*, 309 U.S. 18, 21–22, 60 S.Ct. 413, 414–415, 84 L.Ed. 554 (1940); *Hooe v. United States*, 218 U.S. 322, 336, 31 S.Ct. 85, 89, 54 L.Ed. 1055 (1910).

[10, 11] Since this case does not fall within the rubric of the *Rail Cases*, "it follows that the asserted entitlement to money damages depends upon whether any federal statute 'can fairly be interpreted as mandating compensation by the Federal Government for the damage sustained.'" *Testan*, supra, 424 U.S. at 400, 96 S.Ct. at 954, quoting *Eastport-Steamship Corp. v. United States*, 372 F.2d 1002, 1009, 178 Ct.Cl. 599, 607 (1967). Plaintiffs have pointed to no such statute. Indeed the only arguably[6] applicable statute is the Federal Tort Claims Act, 28 U.S.C. § 2671 et seq., but it provides plaintiffs no foundation for recovery since they have failed to exhaust their administrative remedies. See 28 U.S.C. § 2675; *Bialowas v. United States*, 443 F.2d 1047, 1049 (3d Cir. 1971).

Accordingly, the complaint against the United States must also be dismissed.

Howard M. LASKER and Irving Goldberg, Plaintiffs,

v.

Harry G. BURKS, Jr., et al., Defendants.

No. 73 Civ. 552 (HFW).

United States District Court, S. D. New York.

Jan. 7, 1977.

Two stockholders of registered investment company brought stockholders' derivative action against company's investment advisor and several and present members of the company's board of directors to recover damages for purchase of 270-day notes of issuer which subsequently became bankrupt. Following denial of defendants' motion to dismiss without prejudice, 404 F.Supp. 1172, the defendants renewed their motion to dismiss. The District Court, Werker, J., held that since nondefendant minority directors sought dismissal of action, plaintiffs had burden to establish that minority directors' actions lacked independence; and that unsupported contentions of plaintiffs failed to meet burden of establishing that minority directors' actions lacked independence precluding decision to abandon derivative claims raised in suit, and thus both corporate and individual defendants could not be required to proceed to a trial.

5. It will be noted that a suit against Judge Lord individually would be barred by the doctrine of judicial immunity, see *Pierson v. Ray*, 386 U.S. 547, 87 S.Ct. 1213, 18 L.Ed.2d 288 (1967), and a suit against the assistant United States Attorney would present difficult issues of prosecutorial immunity under *Imbler v. Pachtman*, 424 U.S. 409, 96 S.Ct. 984, 47 L.Ed.2d 128 (1976).

6. The Tort Claims Act would not afford a basis for relief against the United States on account of the actions taken by Judge Lord since the Act does not cover members of the judicial branch of government. See *Cromelin v. United States*, 177 F.2d 275 (5th Cir. 1949), cert. denied, 339 U.S. 944, 70 S.Ct. 790, 94 L.Ed. 1359 (1950).

Defendants granted summary judgment.

1. **Federal Civil Procedure** ⇨2533

Since parties had each submitted affidavits and excerpts from extensive deposition testimony to assist in disposition of motion to dismiss, court was required to treat motion as one for summary judgment under rule 56. Fed.Rules Civ.Proc. rules 12(b), 56, 28 U.S.C.A.

2. **Corporations** ⇨310(1)

Fact that each of minority directors knew someone on board at time that he or she was nominated did not require preclusion of business judgment rule permitting minority of board to determine what position company should take in stockholders' derivative suit, where relationships which existed between minority directors and defendant directors were de minimis.

3. **Banks and Banking** ⇨314

Business judgment rule, permitting disinterested directors who were minority of board to determine decision to be taken in stockholders' derivative suit against, inter alia, investment advisor was not inapplicable merely because each minority director had received remuneration for service on boards of other mutual funds advised by investment advisor.

4. **Banks and Banking** ⇨314

Application of business judgment rule permitting disinterested directors who were minority of board to determine what position company should take in stockholders' derivative suit was not rendered inapplicable on theory that a minority director of a mutual fund can never act independently given the relationship between mutual funds and their advisors.

5. **Securities Regulation** ⇨214

It was not inappropriate for attorney, who advised investment company, to participate in deliberations of disinterested directors, who were minority of board, prior to determination as to what position investment company should take in stockholders' derivative suit, since designating attorney as an interested person only served to limit his participation on board as a director and did not mean that minority directors were interested in suit or that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence. Investment Company Act of 1940, §§ 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-2(a)(19)(A)(iv), 80a-10.

6. **Banks and Banking** ⇨314

Presence of several defendant directors during initial presentations at meeting of disinterested quorum did not demonstrate minority directors' lack of independence thus precluding determination of position company should take in stockholders' derivative suit on behalf of investment company, since minority directors had invited such defendants to join meeting and such defendants and counsel were excused before disinterested quorum made its determination.

7. **Securities Regulation** ⇨214

Even if minority directors erred in determination made during deliberations as to what position investment company should take in stockholders' derivative suit, court could not upset their reasoned judgment without some showing that independence of disinterested quorum was impermissibly curtailed. Investment Company Act of 1940, §§ 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-2(a)(19)(A)(iv), 80a-10.

8. **Securities Regulation** ⇨220

In investment company's stockholders' derivative action against company's investment advisor and several former and present members of company board of directors, since nondefendant minority directors sought dismissal of action, plaintiffs had burden to establish that minority directors' actions lacked independence. Investment Company Act of 1940, §§ 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-2(a)(19)(A)(iv), 80a-10.

9. **Securities Regulation** ⇨219

In investment company's stockholders' derivative action against company's investment advisor and several former and

present members of company's board of directors, unsupported contentions of plaintiffs failed to meet burden of establishing that minority directors' actions lacked independence precluding decision to abandon derivative claims raised in suit, and thus both corporate and individual defendants could not be required to proceed to a trial. Investment Company Act of 1940, §§ 1 et seq., 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-1 et seq., 80a-2(a)(19)(A)(iv), 80a-10.

10. **Corporations** ⇨310(1)

The existence of a casual relationship among directors, without more, cannot be taken as an indication that minority directors were unable to reach an independent business decision and make determination to abandon derivative claims.

11. **Securities Regulation** ⇨214

Fact that Investment Company Act terms an attorney whose advice is sought to be an "interested person" could not suggest that minority directors had an interest in contested transaction which went beyond a generalized concern for the security of the investment company thus precluding exercise of business judgment in determination to abandon derivative claims in investment company's stockholders' derivative action. Investment Company Act of 1940, §§ 1 et seq., 2(a)(19)(A)(iv), 10, 15 U.S.C.A. §§ 80a-1 et seq., 80a-2(a)(19)(A)(iv), 80a-10.

12. **Federal Civil Procedure** ⇨2470.1

Summary judgment may not be granted unless, drawing all reasonable inferences in favor of the nonmovant, no material factual issue is shown. Fed.Rules Civ.Proc. rule 56, 28 U.S.C.A.

13. **Federal Civil Procedure** ⇨2544

Party opposing summary judgment motion must adduce something beyond conclusory allegations. Fed.Rules Civ.Proc. rule 56, 28 U.S.C.A.

Aranow, Brodsky, Bohlinger, Benetar & Einhorn, New York City, by Anthony L.Tersigni, Herbert A. Einhorn, David J. Sweet, Steven Mallis, New York City, of counsel, for plaintiffs.

Seward & Kissel, New York City, for defendant Fundamental Investors, Inc.

Pollack & Kaminsky, New York City, for defendants Anchor Corp., Burr, Chalker, Haire & Hutchinson.

Dewey, Ballantine, Bushby, Palmer & Wood, New York City, for defendants Burks, Hopkins, Kemmerer, Monroney, Phillips and Wade.

OPINION

WERKER, District Judge.

This action, brought derivatively by two shareholders on behalf of Fundamental Investors, Inc. ("Fundamental" or the "Fund"), a registered investment company, seeks to recover damages resulting from the Fund's purchase of $20 million in 270-day notes issued by the now bankrupt Penn Central Transportation Company. The defendants are Anchor Corporation ("Anchor"), the registered investment adviser to the Fund, and several past and present members of the Fund's Board of Directors ("Board"). The defendants previously moved to dismiss this suit under Rule 12(b) of the Federal Rules of Civil Procedure because a voting quorum of disinterested directors found, in the exercise of its business judgment, that maintenance of the suit would not be in the best interests of the shareholders of the Fund. In a memorandum decision on that motion, 404 F.Supp. 1172, this court held that the business judgment rule[1] applied to the actions of the

1. Under the rule,

"' . . . Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.' *Politz v. Wabash R. Co.*, 207 N.Y. 113, 124, 100 N.E. 721, 724. Indeed, although the concept of 'responsibility'

Fund and that it enabled the minority directors of the Board to seek dismissal of this suit provided only that they were "truly disinterested and independent." However, the court permitted the plaintiffs to conduct discovery for a designated period of time to determine whether the minority directors were in fact disinterested or independent, and the motion to dismiss was denied without prejudice to renew at the close of discovery. In accordance with that decision, the defendants have now renewed their motion to dismiss the instant action. The plaintiffs continue to argue that the motion should be denied because, for various reasons, the minority directors did not, and could not, exercise their independent business judgment in moving to terminate this action.

I

The facts surrounding this action have been described at length in my earlier memorandum decision; nevertheless, some repetition of that discussion will facilitate an understanding of the court's action upon the present motion by the defendants.

The complaint alleges, among other things, that Anchor breached its statutory, contractual and common law fiduciary duties by relying exclusively upon the representations of *Goldman, Sachs & Co.* (a seller of commercial paper), rather than independently investigating the quality and safety of the Penn Central 270-day notes purchased by the Fund. It is further alleged that the defendant directors knew or should have known of Anchor's failure to meet its responsibility; that they violated their common law duties as corporate fiduciaries by acquiescing in Anchor's omissions; that the financial condition of the Penn Central steadily worsened during the period from November 28, 1969 to June 21, 1970, the date that it filed for reorganization; and that during this period of decline all of the defendants failed to investigate and review the financial condition of the Penn Central and the quality and safety of its commercial paper. It is also alleged that during this period Anchor failed to recommend, and the defendant directors failed to attempt, sale of the Penn Central paper held by the Fund.

Prior to the institution of this action, the Fund and other plaintiffs brought suit against *Goldman, Sachs* seeking rescission of their purchases. *See Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974) (the "*Welch*" action). On the motion of all defendants to this action, Judge Gurfein, then a district court judge, granted a stay of further proceedings in this action pending resolution of the Fund's claims in *Welch*. Thereafter, on July 9, 1974 the Fund agreed to settle its claims against *Goldman, Sachs*. Under the terms of the settlement agreement, *Goldman, Sachs* was to take back the notes and the Fund was to receive $5,250,000 in cash and a 73.75 percent interest in any proceeds of the notes obtained during the course of the Penn Central reorganization proceeding.

With the claims of Fundamental in the *Welch* matter resolved, the Board once again faced the question of what to do in the instant action. Briefly, the Board determined that five of its members were disinterested (the "disinterested quorum" or "minority directors") and therefore able to determine the proper course of action for the Fund.[2] The disinterested quorum then retained the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the circumstances surrounding the purchase and retention of the Penn Central notes and prepare an opinion for its consideration. In a memorandum to the disinterested quorum dated December 5, 1974, Judge Fuld concluded that neither Anchor nor the defendant directors of the

is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." *Bayer v. Beran*, 49 N.Y.S.2d 2, 6 (Sup.Ct. 1944).

2. Under Article Eight of the Certificate of Incorporation of Fundamental, a quorum of the Board may not be less than one-third of the total number of directors. Since the full Board consisted of ten members, there was no problem here.

Fund had violated the law "in connection with the acquisition or retention of the Penn Central commercial paper." Judge Fuld's memorandum discussed several positions that the disinterested quorum could take on behalf of the Fund, one of which was concluding that the suit lacked merit and moving to dismiss. The minority directors met with Judge Fuld at a special meeting of the disinterested quorum held on December 18, 1974 and requested that he submit a further memorandum before they took any action. The minority directors also questioned several of the defendants before deciding at a second special meeting of the disinterested quorum, held on January 6, 1975, to seek dismissal of the instant action.[3] An affidavit submitted by the chairman of the disinterested quorum as part of the earlier motion to dismiss recounts ten factors that the disinterested quorum considered in arriving at its decision. The relevant portion of that affidavit appears in my earlier decision, 404 F.Supp. at 1176–77.

II

On the defendants' initial motion to dismiss, this court considered and rejected the contention of the plaintiffs that the merits of their derivative claim should color the court's consideration of the business judgment "defense." The court also reviewed the claim of the plaintiffs that the strong public policy behind the Investment Company Act of 1940, 15 U.S.C. § 80a–1, *et seq.*, and the Investment Advisers Act of 1940, 15 U.S.C. § 80b–1, *et seq.*, precluded application of the business judgment rule to the actions of mutual funds. The court observed that

"absent a statutory exception whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation, including whether to prosecute a cause of action. 404 F.Supp. at 1180.

Both of these contentions have been reasserted in substantially unchanged form in the plaintiffs' papers in opposition to the renewed motion to dismiss. While a certain degree of tenacity is the mark of accomplished counsel, what the plaintiffs now seek is an opportunity to reargue the court's prior decision after the time to do so has passed. To accede to that request would require the court to reconsider arguments previously rejected without having been shown that there is a need to do so. Consequently, the court will only consider the question it did not reach before: whether the minority directors were disinterested and independent.

[1] Since the parties have each submitted affidavits and excerpts from the extensive deposition testimony to assist in the disposition of the instant motion, the court must treat the motion as one for summary judgment under Rule 56 of the Federal Rules of Civil Procedure. Rule 12(b), Fed. R.Civ.P.

III

The plaintiffs first contend that the structure of the mutual fund industry, which subjects mutual funds to extensive control by their investment advisers, precludes a finding of independence in this instance.[4] Specifically, they maintain that the large number of shareholders in the Fund coupled with the small size of each

3. As was noted in my earlier decision in this matter, although one of the five minority directors voted by proxy, even without her vote, the presence of four directors at the meeting constituted a quorum.

4. In this regard, plaintiffs note Chief Judge Kaufman's recent statement that:

"The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser." *Galfand v. Chestnutt Corp.*, Civ. No. 76–7156 (S.D.N.Y. Nov. 4, 1976).

shareholder's interest, makes proxy contests impossible to wage and ensures that the Board will only contain directors amenable to the policies of the Fund's management.[5] The plaintiffs also suggest that the service of each minority director for compensation on the boards of other "Anchor" funds demonstrates their inability to act independently. In this vein, the plaintiffs maintain that business and personal relationships among the defendants and minority directors make it impossible to conclude that the disinterested quorum acted independently; that even if the minority directors acted in good faith, their loyalties must have been divided.

[2] Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently. Although each of the minority directors knew someone on the Board at the time that he or she was nominated, the relationships which existed between the minority directors and the defendant directors were *de minimis*, even as they are stated by the plaintiffs, and do not suggest that the business judgment rule should not be applied.

[3] There is also no reason to conclude that the business judgment rule is inapplicable merely because each minority director receives remuneration for service on the boards of other "Anchor" funds. Most corporate directors receive some compensation for their services, but absent a showing of improper motive they have always been permitted to apply their business judgment to decisions involving derivative suits brought against the corporations they serve. *See, e. g., Warshaw v. Calhoun*, 43 Del.Ch. 148, 221 A.2d 487 (Sup.Ct.1966). I am not persuaded that there is any meaningful distinction between remuneration by one corporation rather than several corporations similar in structure. This is not, after all, an instance where it is alleged that a minority director received payments from the investment adviser or other persons whose interests conflict with those of the Fund.

[4] The plaintiffs' contention that a minority director of a mutual fund can never act independently given the relationship between mutual funds and their advisers parallels, to some extent, their previously rejected argument that the business judgment rule should not apply to mutual funds registered under the Investment Company Act of 1940. In making this claim, plaintiffs apparently rely upon *Fogel v. Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976), but that decision is inapposite. In the *Fogel* case, two mutual fund stockholders brought a derivative suit on behalf of a mutual fund against several affiliated fund directors and the advisor to the fund. The plaintiffs sought to recapture a portion of the brokerage commissions paid on fund transactions on the theory that the affiliated directors had "intentionally misled and misinformed the [f]und's unaffiliated directors by telling them that such recapture was not available to the [f]und." *Id.* at 737.

Writing for the *Fogel* panel, Judge Friendly observed that:

> "Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the [f]und's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by

5. At about the time that the minority directors determined to seek the dismissal of this action, there were approximately 141,000 shareholders in the Fund. No shareholder had a beneficial interest greater than one percent.

> disinterested counsel furnished to the independent directors."

Id. at 749–50.

Significantly, Judge Friendly went on to observe that:

> "If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the [f]und should make no effort at recapture, we would have a different case."

Id. at 750.

In the instant action, the minority directors were furnished with disinterested counsel who analyzed the legal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them. Clearly, then, under *Fogel* it was proper for them to determine what the Fund's posture would be.

IV

The plaintiffs next contend that the lack of true independence and disinterestedness on the part of the minority directors is apparent from the manner in which they decided to seek dismissal in the instant action. In support of this claim, plaintiffs point to the actions of Roger T. Wickers, an Anchor vice-president who formerly served as the secretary to the Fund, and Eugene P. Souther, who was retained as special counsel to the Fund for the purposes of this litigation, as well as to the circumstances surrounding the meetings of the minority directors.

At the direction of defendant Haire, Wickers explored the possibility of retaining special counsel for the disinterested quorum. After contacting several distinguished attorneys, Wickers reported that Judge Fuld would be available to serve the minority directors and, at a Board meeting held on July 24, 1974, it was Wickers who proposed that a disinterested quorum act for the Fund in the instant action. Wickers also coordinated the arrangements for Judge Fuld's investigation for the minority directors, who were residents of several different states.

The plaintiffs maintain that "the inappropriateness of Wickers role as intermediary is manifest," but I disagree. The plaintiffs have not set forth any facts in support of their suggestion that Wickers improperly influenced the deliberations of the disinterested quorum. Instead they have engaged in totally unsubstantiated supposition. For example, plaintiffs contend that Wickers retained Judge Fuld, but the sworn affidavit of Wickers and the deposition of a least one minority director establish that Judge Fuld was retained by the minority directors to act upon instructions communicated to him at the direction of the disinterested quorum.[6] In the absence of some factual support for the plaintiffs' allegations, the court cannot conclude that it was improper for Wickers to coordinate the administrative details of Judge Fuld's inquiry or that Wickers' actions reduced the independence of the minority directors.

[5] It is the court's opinion that the role of Souther was equally innocent. The plaintiffs advance two reasons why it was inappropriate for him to participate as he did in the deliberations of the disinterested quorum. First, they note that he was an "interested person" within the meaning of § 2 of the Investment Company Act, 15 U.S.C. § 80a–2(a)(19)(A)(iv)[7] because his

6. Even if Wickers did retain Judge Fuld for the minority directors, I see nothing improper in that. In fact, in *Fogel, supra*, Judge Friendly suggested that it was desirable for disinterested counsel to be "*furnished*" to the independent directors.

7. Under the statute:

"(19) 'Interested person' of another person means—

(A) when used with respect to an investment company—

* * * * * *

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company . . ."

law firm had acted as legal counsel to the Fund during the last two fiscal years. They question whether the minority directors could arrive at a disinterested decision when they were advised by an attorney who was "interested." Second, the plaintiffs contend that it was improper for his firm to counsel parties with divergent interests, namely the Fund and the disinterested quorum.

All attorneys providing legal counsel to mutual funds become, by definition, "interested persons" for some period of time. Under § 10 of the Investment Company Act, 15 U.S.C. § 80a–10, only 60 percent of the members of the board of a registered company may be interested persons. Designating Souther as an interested person, therefore, only serves to limit his participation on the Board *as a director.* It does not mean that the minority directors were interested in the suit, that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence.

Plaintiffs nevertheless suggest that in accordance with Judge Frankel's recent decision in *Papilsky v. Berndt,* CCH Fed.Sec.L. Rep. ¶ 95,027 (S.D.N.Y.1976), it was improper for Souther to advise both the Fund and the minority directors. However, in *Papilsky* the law firm advising the fund also served as the investment adviser's counsel, and, as Judge Frankel noted, there was no "suggestion to the Board that, because of the possible conflict of interest, the independent directors should seek disinterested counsel." *Id.* at 90, 133. In the instant action, independent legal advice for the minority directors was not only recommended, it was also obtained. Moreover, there was no conflict of interest on the part of Souther or his law firm: they were retained to represent the Fund in the instant action and it was the disinterested quorum, acting for the Fund, which gave them their instructions as to how to proceed.

[6] The plaintiffs also contend that the presence of several defendants during the initial presentations of Judge Fuld and Souther at the first special meeting of the disinterested quorum demonstrates the minority directors' lack of independence. But the minutes of that meeting and the deposition testimony show that the minority directors invited those defendants to join the meeting so that they could answer questions raised by the minority directors. The minutes of the meeting also indicate that all of the defendants and counsel were excused before the disinterested quorum determined in executive session that it wished to review the pertinent documents and formulate further questions to be answered before reaching any decision.

In this context plaintiffs point to the allegedly misleading nature of statements made to the minority directors by defendant Haire. The minutes of the first special meeting of the disinterested quorum state that Haire "questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if [the instant action] were being pursued with the acquiescence, if not under the control, of the Fund." The plaintiffs consider this to be in sharp disagreement with Haire's testimony at his disposition that he "never at any time had any doubt that [Anchor] could continue to effectively serve the [F]und if . . . requested to continue or permitted to continue by the board or the shareholders." Apparently to underscore the materiality of Haire's discouraging words to the minority directors, plaintiffs note the contents of an affidavit by the chairman of the disinterested quorum. In that affidavit, the quorum chairman states that in reaching their decision the directors considered that:

> "(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment advisor and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders . . . ."

[7] The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows only the the minority directors reached a different conclusion: that prosecution of the suit "would necessarily cause the Fund to seek to obtain a different investment adviser immediately." Even if the minority directors erred in this determination, as I have noted in my previous decision, the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence.

V

Finally, the plaintiffs contend that under *Perlman v. Feldman,* 219 F.2d 173, 178 (2d Cir.), *cert. denied,* 349 U.S. 952, 75 S.Ct. 880, 99 L.Ed. 1277 (1955), and *Pepper v. Litton,* 308 U.S. 295, 306, 60 S.Ct. 238, 84 L.Ed. 281 (1939), the defendant directors bear the burden of proving by clear and convincing evidence that they did not breach their fiduciary responsibilities to the corporation and its stockholders. The defendants argue that the plaintiff must shoulder the evidentiary burden because it is the exercise of business judgment by corporate directors which is challenged. *Bellis v. Thal,* 373 F.Supp. 120, 124 (E.D.Pa.1974), *aff'd,* 510 F.2d 969 (3d Cir. 1975); *Marco v. Bank of New York,* 272 F.Supp. 636, 639 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 628 (2d Cir. 1968); *Warshaw v. Calhoun, supra.*

The *Perlman* and *Pepper* cases relied upon by the plaintiffs both involve self-dealing by corporate fiduciaries and are inapplicable here. As I noted in my earlier decision in this matter, the plaintiffs "have not argued that the minority directors have acted fraudulently or corruptly." 404 F.Supp. at 1180. Moreover, the question before the court is not whether *the defendants* breached their fiduciary obligations to the corporation, but whether suit can proceed against them at all given the decision of the nondefendant minority directors to seek dismissal of this action.

[8, 9] It is therefore incumbent upon the plaintiffs to establish that the minority directors actions lacked independence. *Marco v. Bank of New York, supra.* The unsupported contentions of the plaintiffs clearly fail to meet this burden and, accordingly, it is the opinion of this court that the defendants, both corporate and individual, cannot be required to proceed to a trial. I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so. The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit.

[10, 11] To conclude that the disinterested quorum acted in response to pressure and without justification to immunize Anchor and the defendant directors from possible liability would require this court to presume that bias exists based upon circumstances which seem entirely innocent. For example, as has been noted, the plaintiffs suggest that a finding of improper influence must follow from the fact that the minority directors each knew someone on the Board when they were first selected for nomination or election to the Board. But the existence of casual relationships among

the directors, without more, cannot be taken as an indication that the minority directors were unable to reach an independent business decision. Similarly, because the Investment Company Act terms an attorney whose advice is sought to be an "interested person," plaintiffs seek to suggest that the minority directors had an interest in the contested transaction which went beyond a generalized concern for the security of the Fund.[8] But here again it was obviously reasonable for the minority directors to consult with interested persons, rather than reaching a decision without speaking to either the directors involved in the transaction or counsel.

[12, 13] The court of appeals for this circuit has recently cautioned that summary judgment may not be granted unless, drawing all *reasonable* inferences in favor of the nonmovant, no material factual issue is shown. *Heyman v. Commerce and Industry Insurance Co.*, 524 F.2d 1317 (2d Cir. 1975). However, the party opposing the motion must adduce something beyond conclusory allegations. *Donnelly v. Guion*, 467 F.2d 290 (2d Cir. 1972). Here, there has been no showing by the plaintiffs of facts which, if proven, would prohibit the defendants from hiding behind the business judgment cloak. Accordingly, the defendants are granted summary judgment.

SO ORDERED.

Joseph THOMPSON et al.

v.

Victor YUE.

Civ. A. No. 76-1126.

United States District Court,
D. New Jersey.

Jan. 10, 1977.

Personal injury action was brought in Federal District Court, sitting in New Jersey, as result of automobile accident in Quebec, Canada, involving Illinois plaintiffs and a New Jersey defendant. On defendant's motion for summary judgment on grounds that suit was time barred by Quebec's one-year personal injury statute of limitations, the District Court, Barlow, J., held that New Jersey's conflicts of law principles were binding on the court; and that, on the basis of its factual contacts with the case, New Jersey's substantive law would be applied, including its two-year limitation period.

Defendant's motion for summary judgment denied.

1. Federal Courts ⟹409

Federal court sitting in diversity is bound to apply choice of law rules of forum state.

2. Federal Courts ⟹409

In personal injury action initiated in federal court sitting in New Jersey, arising from automobile accident which occurred in Quebec, Canada, involving Illinois plaintiffs and New Jersey defendant, New Jersey's conflicts of law principles were applicable and binding on court.

3. Limitation of Actions ⟹2(1)

Where suit is brought on foreign cause of action in New Jersey court, court will not employ state's statute of limitations but

8. In a similar effort to brand a minority director as interested, plaintiffs point to the following testimony by director Stephens:

> "I remember commenting [at the July 24, 1974 board meeting] on what constituted a disinterested director because in my opinion no director could be disinterested, but I was told that was the proper term.

Later Stephens explained that he didn't like the term "disinterested" since he certainly was not "uninterested."

Opinion of the Court of Appeals, January 11, 1978

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 23—September Term, 1977.

(Argued August 31, 1977 Decided January 11, 1978.)

Docket No. 77-7060

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

—v.—

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Defendants-Appellees.

Before:

LUMBARD, OAKES and MESKILL,

Circuit Judges.

Appeal from dismissal in the Southern District, Werker, *J.*, of stockholder derivative suit against directors of mutual fund and fund's investment adviser.

Reversed.

ANTHONY L. TERSIGNI, New York, N.Y. (Arnow Brodsky Bohlinger Benetar & Einhorn, Steven Mallis, Herbert A. Einhorn, David

J. Sweet and Richard N. Gray, New York, N.Y., on the brief), *for Plaintiffs-Appellants.*

DANIEL A. POLLACK, New York, N.Y., *for Defendants-Appellees.*

SEWARD & KISSEL, EUGENE P. SOUTHER and ANTHONY R. MANSFIELD, New York, N.Y., on the brief, *for Defendant-Appellee Fundamental Investors, Inc.*

POLLACK & KAMINSKY and MARTIN I. KAMINSKY, New York, N.Y., on the brief, *for Defendants-Appellees Anchor Corporation, Edward B. Burr, Thomas F. Chalker, John R. Haire and S. P. Hutchison.*

DEWEY, BALLANTINE, BUSHBY, PALMER & WOOD, LEONARD JOSEPH, JOHN M. FRIEDMAN, JR., New York, N.Y., on the brief, *for Defendants-Appellees Harry G. Burks, Jr., Harvey C. Hopkins, Donald L. Kemmerer, A. S. Mike Monroney, Charles L. Phillips and Jeptha H. Wade.*

LUMBARD, *Circuit Judge:*

This appeal by two mutual fund shareholders raises an important question of first impression: Can minority directors of a registered mutual fund, who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act, 15 U.S.C. §80a-10(a), terminate a nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser? We are of the view that to permit such action by those "independent"

minority directors of a registered mutual fund would be contrary to the public interests which Congress has sought to protect. Accordingly, we reverse the judgment of the district court which dismissed the complaint and remand for further proceedings.

Howard Lasker and Irving Goldberg commenced this derivative action in February, 1973, against individuals who had been directors of Fundamental Investors. Inc. (the Fund), an open-end investment company[1] registered under the Investment Company Act, 15 U.S.C. §80a-1 to -52, and the Fund's registered investment adviser, Anchor Corporation. The plaintiffs sought to recover losses sustained by the Fund in connection with its purchase between November 28 and December 8, 1969, of $20 million in Penn Central 270-day notes from Goldman, Sachs & Co. The derivative complaint charged the defendants with violations of §§13(a)(3) and 36 of the Investment Company Act. 15 U.S.C. §§80a-13(a)(3), 80a-35 (1970), breach of their common-law fiduciary duties, violations of §206 of the Investment Advisers Act, 15 U.S.C. §80b-6 (1970), and breach of Anchor's investment advisory contract with the Fund.

It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment. On June 21, 1970, Penn Central filed a petition for reorganization which is still in process in the Eastern

1 An open-end investment company is defined in §5(a)(1) of the Investment Company Act, 15 U.S.C. §80a-5(a)(1) (1970), as an investment company that offers "for sale or has outstanding any redeemable securities of which it is the issuer." "Investment company" is defined in §3(a) of the Act, 15 U.S.C. §80a-3(a) (1970).

District of Pennsylvania. Consequently, the Fund's Penn Central notes were not paid at maturity.

In November 1970, the Fund, joined by three other noteholders,[2] sued Goldman, Sachs in the Southern District of New York for recovery of their losses arising from their purchases of Penn Central notes. In July 1973, then District Judge Gurfein stayed the instant action, which had been commenced five months earlier, pending resolution of the suit against Goldman, Sachs. That suit was settled on behalf of the Fund in July 1974. Under the settlement, Goldman, Sachs took back the Fund's Penn Central notes, paid the Fund $5,250,000, and assigned to the Fund a 73.75 per cent interest in the proceeds of the notes in the reorganization proceedings. The Fund's co-plaintiffs did not settle, and the jury rendered verdicts in their favor against Goldman, Sachs for the full amount of their claims.[3]

On July 24, 1974, the Fund's board of directors met and discussed the pending *Lasker* case. They decided that five of the statutorily disinterested directors, none of whom were involved in the derivative action,[4] should decide what action should be taken regarding the *Lasker* case, and act accordingly on behalf of the entire board.[5] This procedure

2 In addition to the Fund, Welch Foods, Inc., C.R. Anthony Company, and Younker Brothers, Inc. sued Goldman, Sachs in a single action. See *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974).

3 See *Welch Foods Inc. v. Goldman, Sachs & Co.*, No. 70 Civ. 4811 (jury verdict S.D.N.Y. 1974).

4 Of the remaining six directors of the eleven member board, all were defendants to the *Lasker* action and/or affiliated with Anchor.

5 Under the Fund's bylaws and Delaware corporate law, five of the Fund's twelve member board of directors constituted a quorum of the entire board. Del. Code tit. 8, §141 (1975); Fundamental Investors, Inc., Certificate of Incorporation, Article EIGHTH; Fundamental Investors, Inc., Bylaws section 4, Article VI.

The five directors appointed to review the *Lasker* action were: Leon Kendall, elected to the board in June 1974; Beryl Robichaud, elected

had been discussed prior to the July board meeting by the defendant John R. Haire, president of the Fund and chairman of Anchor's board of directors, and Roger Wickers, an officer of both the Fund and Anchor. Upon Haire's instruction, Wickers had ascertained that Stanley H. Fuld, former chief judge of the New York Court of Appeals, would be available to serve as special counsel. The minority directors agreed to consider what should be done about the *Lasker* case, and instructed Wickers to retain Judge Fuld to advise them.

Judge Fuld, in his report of December 5, 1974, supplemented on December 18, 1974, concluded, on the basis of the information furnished to him, that neither Anchor nor the Fund directors would be found liable under federal or state law. At the same time, Judge Fuld pointed out the absence of legal authority on whether a mutual fund's investment adviser is required to conduct independent research regarding its investment recommendations. He further cautioned that it was "impossible to predict . . . what a trier of fact will find, particularly in complex circumstances." After considering the special counsel's reports, on January 6, 1975, the minority directors instructed counsel for the Fund to seek dismissal of the *Lasker* action on the ground that it was their business judgment that further prosecution of the action would not be in the best interests of the Fund.

Judge Werker, in passing on the motion to dismiss, held that the minority directors, in the exercise of their business judgment, had the power to bar further prosecution of the case, provided they were truly disinterested and independent. As a factual issue had been raised regarding whether the minority directors were independent and disinterested,

in September 1973; William Stephens, elected in September, 1973; Mary O'Connor, elected in June 1972; and Louis Laun, who became a director in the fall of 1971.

he granted discovery on that issue. *Lasker v. Burks,* 404 F.Supp. 1172 (S.D.N.Y. 1975). After such discovery, the motion to dismiss was renewed and granted by Judge Werker on January 7, 1977. In his second opinion, 426 F.Supp. 844 (S.D.N.Y. 1977), Judge Werker found no factual support for the conclusion that the minority directors had not acted independently. In accordance with his earlier opinion, he dismissed the complaint.

From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses. We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.

In response to disclosure of grave abuses in the management of investment companies, Congress in 1940 enacted the Investment Company Act (ICA), 15 U.S.C. §§80a-1 to -52 (1970), and the Investment Advisers Act (IAA). 15 U.S.C. §§80b-1 to -21 (1970). Congress acted after receiving a report from the Securities and Exchange Commission which showed that investment funds were organized by investment advisers; that the funds were administered under

contracts that were highly favorable to the advisers; that the directors of the funds were selected by the investment adviser; and that the board was usually dominated by persons affiliated with the adviser.[6] Congress found that numerous practices in the management of such funds adversely affected the national public interest and the interest of investors. Accordingly, Congress declared it to be the policy and purpose of the ICA to mitigate and eliminate those aspects of the conduct and administration of the funds which benefited the managers and adversely affected the stockholders of the fund.[7]

The ICA provides that no more than 60% of a registered company's board of directors can be "interested persons" affiliated with the investment adviser.[8] Moreover, it gives the statutorily disinterested directors, usually referred to as "independent directors," certain powers to supervise management and auditing arrangements.[9] Thus, section 15(c) of the ICA, 15 U.S.C. §80a-15(c) (1970), imposes on the disinterested directors the duty to review and approve the contracts of the investment adviser and the principal underwriter; section 16(b), 15 U.S.C. §80a-16(b) (1970), provides that the statutorily disinterested directors will appoint other disinterested directors to fill vacancies resulting from the assignment of the advisory contracts; and section 32(a), 15 U.S.C. §80a-31(a) (1970), requires that the accountants who prepare the investment company's Securities and Exchange Commission financial fil-

6 See SEC, Report on the Study of Investment Trusts and Investment Companies, pt. 3, 1-49, 1922 (1940). See also Comment, Duties of the Independent Directors in Open-End Mutual Funds, 70 Mich.L.Rev. 696, 701 (1972).

7 15 U.S.C. §80a-1 (1970).

8 See 15 U.S.C. §§80a-10, 80a-2(a)(3), (19) (1970).

9 See generally Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich.L.Rev. 696 (1972).

ings be selected by the statutorily disinterested directors. We conclude, therefore, that the statutes were designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Congress has not been satisfied, moreover, that the presence of disinterested directors who observe their duties will be sufficient protection to the stockholders, as it has specifically provided in section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser and the principal underwriter. See 15 U.S.C. §80a-35(b) (1970). Section 36(b) was enacted as a part of the 1970 amendments, which resulted in part from the Senate report which indicates that the mere presence of disinterested directors on the boards of mutual funds was not sufficient to protect funds against overreaching investment advisers.[10]

We have been sensitive to the need for protection of the public interest in accordance with the views of Congress. Thus, in *Galfand* v. *Chestnutt*, 545 F.2d 807 (2d Cir. 1976), we found that the investment adviser had abused its position of trust by securing a favorable modification of its advisory contract without fully disclosing to the fund's directors the ramifications of the changes. Writing for the panel, Chief Judge Kaufman observed that, "[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which

10 See 1970 U.S. Code Cong. & Admin. News, 4897, 4901. In 1970 both the ICA and the IAA were substantially amended. See Act of December 14, 1970, Pub.L.No. 91-547, 84 Stat. 1413.

selects its portfolio and administers its daily business." Id. at 808. See also *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir. 1977).

Moreover, in many instances where no specific authority is granted by statute the courts have inferred that stockholders may bring suit. See, e.g., *Abrahamson* v. *Fleschner*, No. 75-7203, slip op. at 6227-29 (2d Cir. Feb. 25, 1977) and cases cited therein. It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.

In the ordinary routine business of running an investment trust, the disinterested directors must constantly deal with interested directors in a spirit of accommodation. Indeed, they are compelled for the most part to rely on the information and expert advice provided by the adviser and the majority directors.[11] The continued service of the "statutorily" disinterested directors, for which in this case they were paid from $11,000 to $13,000 *per annum*,[12] depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection. It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for

11 See Comment, supra note 9, at 702.

12 In addition to their role as directors of the Fund, each of the five minority directors served on the boards of five other Anchor affiliated funds, and all but one of the directors sat on a sixth Anchor related board.

the individuals concerned.[13] Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuance of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties. Of course here we do not reach the question of whether a court should defer to the decision of statutorily disinterested directors of an investment company to terminate a shareholder derivative suit which the court finds to be frivolous.

Our conclusion makes it unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent to determine that the litigation be ended.[14] We have no doubt that the five minority directors acted in good faith in all that they did.

Reversed and remanded for further proceedings.

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13 See *Fogel v. Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975); Nutt, A Study of Mutual Fund Independent Directors, 120 U.Pa.L.Rev. 179, 216 (1971).

14 Similarly, the plethora of cases cited by counsel dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite. We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations. Moreover, none of these cases involves the situation here, where the terminating directors owe their position as directors to the defendants in the suit.

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*, *Petitioners*,
v.
HOWARD M. LASKER, *et ano.*, *Respondents*.

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF OF INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE IN SUPPORT OF DEFENDANTS' PETITION FOR A WRIT OF CERTIORARI

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BRIEF OF INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE IN SUPPORT OF DEFENDANTS' PETITION FOR A WRIT OF CERTIORARI

Investment Company Institute ("ICI") files this brief, as *amicus curiae*, in support of the petitioners' prayer that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered herein on January 11, 1978.

This brief is filed with the consent of the parties herein.[1]

[1] The consent of respondents was conditioned on the filing of this brief within seven days of the petition for a writ of certiorari. The petition herein was filed on June 2, 1978.

I. INTEREST OF THE AMICUS CURIAE

ICI is the national association of open-end investment companies (mutual funds), their investment advisers and principal underwriters. ICI has 453 investment company members, with approximately seven million shareholders. Their assets are approximately $48 billion and account for over 90 percent of the total assets of the mutual fund industry. All of the mutual fund members of ICI are registered with the Securities and Exchange Commission under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.*

ICI is concerned that, if permitted to stand, the Court of Appeals opinion will undermine the statutory role of independent, disinterested mutual fund directors; will leave the law concerning the authority and responsibilities of such directors in a state of confusion and disarray; and will result in the needless maintenance of derivative actions which the independent directors would otherwise determine, in the reasonable exercise of their discretion, not to be in the interest of the funds whose affairs they are authorized to govern. For the reasons stated *infra,* ICI respectfully submits that the decision of the Court of Appeals below was incorrect as a matter of law and, if permitted to stand, will substantially impair the proper operations of publicly held mutual funds under applicable state and federal law—to the detriment of both the industry and the investing public at large.

II. OPINIONS BELOW

The opinion of the Court of Appeals (Pet. App., p. 24a) is reported at 567 F.2d 1208. The opinions of the District Court (Pet. App., pp. 14a, 1a) are reported at 426 F. Supp. 844 and 404 F. Supp. 1172.

III. JURISDICTION

The judgment of the Court of Appeals was entered January 11, 1978. A timely petition for rehearing was denied by order entered March 9, 1978. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. § 1254(1).

IV. QUESTION PRESENTED

ICI adopts by reference the question stated by petitioners.

V. STATUTORY PROVISIONS INVOLVED

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. §§ 80a-35(a), 35(b) (1970), and the Delaware General Corporation Law, 8 Del. Code §§ 141(a), 141(b) (1974).

VI. STATEMENT OF THE CASE

The pertinent facts as well as a descriptive history of the proceedings to date are set forth in the petition.

To summarize briefly, this case was commenced by two shareholders in Fundamental Investors, Inc. ("Fundamental")—a Delaware corporation which is an open-end investment company (mutual fund) within the meaning of the Investment Company Act—purportedly as a derivative action on behalf of Fundamental. The complaint charged Fundamental's investment adviser, Anchor Corporation ("Anchor"), and all of the directors of Fundamental at the time in question, with violations of statutory and common law duties in connection with the decision in 1969 to make and retain an investment in commercial paper issued by Penn Central Transportation Company, on which payment was not made at maturity.

Following settlement of an earlier action initiated by Fundamental itself against the dealer selling the notes in issue—as a result of which Fundamental recovered a portion of its losses on this investment—a quorum of five disinterested directors, none of whom were directors at the time of the events complained of, undertook to consider what position Fundamental should then take regarding the derivative action. To assist in their deliberations, the disinterested directors retained as special counsel the Honorable Stanley H. Fuld, formerly Chief Judge of the State of New York.

Thereafter, based upon detailed legal and factual memoranda submitted to the Board by Judge Fuld indicating the derivative action to be without merit, and considering the disadvantageous effects of the litigation upon Fundamental (including, *inter alia,* the cost of the litigation and the disruptive effect upon the working relationship between the fund and its investment adviser) (*see* Pet. App., pp. 5a-6a), the disinterested directors decided unanimously that maintenance of the action would not be in the best interest of the shareholders. They determined, therefore, to seek dismissal of the derivative action.

Following extensive discovery on the issue of the independence of the disinterested directors, the District Court concluded that there was no evidence upon which their independence could be challenged. Accordingly, the District Court granted Fundamental's motion to dismiss:

> "If the minority directors were truly disinterested and independent the court will not substitute its judgment for that of the Board." (Pet. App., p. 11a).

On appeal, the Court of Appeals reversed. Although the independent directors' actions were duly authorized under the by-laws of the corporation and applicable Delaware law—and notwithstanding the important responsibilities expressly entrusted to mutual fund independent directors by Congress in the Investment Company Act, as amended [2]—the Court of Appeals felt that it would be "asking too much of human nature" to expect that the disinterested directors would act with the necessary objectivity in these circumstances in light of the "unique nature" of investment companies in general and their "symbiotic relationship" with their investment advisers. (Pet. App., p. 33a).

The record in this case contains no suggestion of bad faith on the part of the disinterested directors or of self-dealing on behalf of any defendant:

1. The District Court found that plaintiffs failed to adduce "*any* factual support for their conclusion that the members of the disinterested quorum acted other than independently" in reaching their determination to seek an end to the derivative action. (Pet. App., p. 19a (emphasis added)). The Court of Appeals stated that it had "no doubt that the five minority directors acted in good faith in all that they did." (Pet. App., p. 33a).[3]

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[2] *See infra* pp. 12-14.

[3] Nor do even the allegations of the complaint charge that the defendant directors and investment adviser realized any personal gain from the fund's purchase of Penn Central commercial paper; rather, the gravamen of the action is that the defendants were remiss in their responsibilities in making, or acquiescing in, the decision to purchase Penn Central paper in light of the information about the financial condition of the company which, plaintiffs charge, might have been obtained at the time of purchase if a more thorough review of the investment had taken place.

2. The record is clear that the disinterested quorum was fully advised; they were aware of the facts and acted in reliance upon the legal advice of distinguished special counsel in reaching their decision. The District Court found, and the Court of Appeals did not dispute, that

> "the minority directors were furnished with disinterested counsel who analyzed the legal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them." (Pet. App., p. 20a).

3. In acting as they did, in part upon Judge Fuld's opinion of the invalidity of the claims asserted in the derivative action and in part upon the substantial business considerations which further militated against maintenance of the action, the disinterested quorum clearly acted well within the parameters of "reasonableness"—assuming that the independent directors are not absolutely barred from so acting by policies which the Court of Appeals saw implicit in the Investment Company Act. The Court of Appeals did not question the "reasonableness" of the independent directors' decision. Rather, the Court of Appeals ruled as a *matter of law* that disinterested mutual fund directors lack the power to terminate a "nonfrivolous" shareholder derivative suit: that is, presumably, any litigation which on its face could withstand a motion for judgment on the pleadings. The Court of Appeals did not cite any specific statutory basis for its conclusion.

This case raises highly significant issues relating to the legal duties and responsibilities of disinterested mutual fund directors, which the Court of Appeals characterized as "an important question of first impression." (Pet. App., p. 25a).

VII. REASONS FOR GRANTING THE WRIT

A. The Decision Below Raises Significant and Recurring Problems Concerning the Authority and Responsibilities of Independent Directors of Mutual Funds Under the Investment Company Act.

The role of disinterested mutual fund directors was first established by the Investment Company Act of 1940 and legislatively reinforced and expanded by the 1970 amendments to that Act. These unaffiliated directors were viewed as "watchdogs" over the interests of the shareholders and charged under the statute with reviewing and approving contracts and matters in which the manager had an interest, such as the fund's management and underwriting contracts.[4] Congress viewed independent directors as providing "an independent check on management. . . ." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

The decision below undercuts the statutory role for independent directors established by Congress and will have significant adverse effects on these directors and the operations of the funds they serve.

On an industry basis, mutual fund managers make literally tens of thousands of investment decisions each year with respect to billions of dollars of assets which are managed for the benefit of millions of shareholders. Each one of these thousands of investment decisions which, with the benefit of hindsight, was a poor deci-

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[4] *See infra* pp. 12-14.

sion gives rise to the possibility of a derivative action in which one or more disappointed shareholders may seek to recover on behalf of the fund the full amount of the loss from the investment adviser, affiliated directors and others.

The role of independent directors, who are not defendants or otherwise personally interested in the outcome of the action, has now been made unclear by the decision below. If the independent members of a mutual fund board of directors determine that the institution or maintenance of the claims set forth in a derivative action would not be in the interest of the fund—*e.g.*, because they determine the claims to be without merit or because of other proper considerations—should they refuse to approve or seek dismissal of the action in accordance with the Securities and Exchange Commission's view that it is the disinterested directors' responsibility to exercise "their business discretion in the best interests of the fund shareholders"?[5] Or, in accordance with the Court of Appeals decision below, must they sit back and refrain from acting so long as the claims asserted in the derivative action are not patently "frivolous"?

If independent directors cannot exercise their reasonable business judgment in such circumstances, the intent of Congress that disinterested mutual fund directors exercise discretion to determine what actions

[5] Brief of the Securities and Exchange Commission, *Amicus Curiae* at 28, *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 98 S. Ct. 421 (1977). The Commission's view also accords with the view of Congress that the provisions of the Investment Company Act were "not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969).

should be taken to protect the interests of all of the shareholders will be frustrated.

For the role of the independent mutual fund director to be an effective one, it is important that individuals of ability, experience and integrity agree to accept these positions. The decision below—which wrongfully withdraws from independent directors their authority to exercise their good faith business judgment in the interest of the fund and which unfairly denigrates such directors as a class by the unsupported assumption that they must be as a matter of law incapable of acting with objectivity—will hinder, not help, efforts to encourage responsible individuals to serve in this role. Rather than enhancing the operation of mutual funds in the interest of the vast majority of shareholders, the decision below will emasculate the role of the "independent watchdog" director that Congress selected as a "key" means of assuring that investment companies are in fact run for the benefit of their shareholders. *See, e.g., Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir.), *cert. denied*, 98 S. Ct. 421 (1977).

B. The Decision Below Will Encourage and Compel the Maintenance of Litigation Which Is Not in the Best Interest of Mutual Fund Shareholders or the Mutual Fund Industry.

If independent mutual fund directors cannot exercise their reasonable business judgment to refuse to approve or seek dismissal of litigation they determine to be not in the best interest of the fund, ICI submits that significant undesirable results can and will occur:

First, costly and time-consuming litigation will be maintained involving claims which the independent directors of mutual funds—the persons most likely to

be both knowledgeable and objective—determine to be without merit or of such little merit as not to justify the expense and other burdens of ongoing litigation. Mutual fund investment advisers regularly make thousands of investment decisions, many of which result in losses and could give rise to litigation. The decision below will operate to remove an existing protection against the maintenance of unsound or questionable suits of this nature, which are unlikely to be in the interests of the funds on whose behalf they purport to be brought or their shareholders. The proliferation of such actions is neither in the public interest nor the interest of the judicial system. *See Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 742-43 (1975).

Second, to the extent that the maintenance of such derivative suits impairs the working relationship between mutual funds and their investment advisers, a derivative action on behalf of one or two shareholders may effectively frustrate the expectation of thousands of other shareholders.[6] If litigation desired by one or two shareholders is allowed to impair the relationship between a fund and its adviser without sufficient cause, the expectations of other investors who have chosen the fund on the basis of its adviser's past performance and reputation will not be realized.

[6] Here, one of the considerations of the disinterested directors was their view that "[i]f the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave . . . no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser." (Pet. App., p. 5a).

Third, the uncontrolled maintenance of the sort of claims involved in this case poses the threat of severe disruption of the operations of the mutual fund industry—particularly with respect to the activities of investment advisers.

Investment advisers to mutual funds typically are entrusted with the management of large amounts of assets, in exchange for which they receive compensation which is customarily calculated on the basis of a small percentage of the fund's assets. In this case, for example, the damages sought could be 200 times as great as the investment adviser's annual fees attributable to management of the assets in question.[7] The spectre of defending lawsuits brought by dissatisfied shareholders essentially seeking to make the investment adviser the guarantor of the investments selected is likely to have an adverse, disruptive effect upon the operations of the mutual fund industry.[8]

C. The Decision Below Improperly Applies the Provisions and Policies of the Investment Company Act to Reach a Result Which Is in Conflict with the 1970 Amendments to That Act and With Controlling State Law.

The quorum of disinterested directors, acting pursuant to the by-laws of the corporation and in accord-

[7] Anchor's contract with Fundamental provided that Anchor would receive approximately .5% of the value of the assets managed as an annual fee. (Jt. App., p. 194A) ("Jt. App." refers to the Joint Appendix filed in the Court of Appeals).

[8] The issues for review in this case will not require the Court to determine whether damages could ever be recovered on this basis and, if so, in what circumstances. ICI merely points out that the *in terrorem* effect of suits seeking damages out of all proportion to an investment adviser's income, if they may be brought at the instance of a single shareholder without any meaningful prior screening, will be substantial.

ance with Delaware law, acted within the scope of their discretionary authority in this case. Directors of corporations generally need not pursue every conceivable legal claim—especially "where the right of the corporation to recover is doubtful":

> "The mere fact that a corporation has a cause of action for an injury does not always make it incumbent upon it to sue, any more than in the case of an individual. If, in the opinion of the directors or a majority of the stockholders, the interests of the company do not require it to sue, it need not do so. The matter ordinarily is within their discretion, and if they act in good faith, their refusal to sue violates no right of dissenting stockholders, so as to entitle them to maintain a suit in their own behalf." 13 *Fletcher Cyc Corp. (Perm Ed)* § 5822 (1970) (footnote omitted).

See, e.g., United Copper Securities Co. v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903); *Ash* v. *IBM*, 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Alleghany Corp.* v. *Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966).

If the result below can be justified, it must be premised upon the Investment Company Act of 1940, which was enacted in part because of the special nature of the investment company industry to which the Court of Appeals referred. However, neither the statute nor its underlying policies (Section 1(b)) compel the departure from established principles indulged in by the Court of Appeals below. On the contrary, they compel precisely the opposite result.

When it amended the Investment Company Act in 1970, Congress specifically considered the problem of the influence exerted by the investment manager over the unaffiliated directors. Congress nevertheless chose to *reject* proposals for significant structural changes in investment company governance and instead adopted additional safeguards keyed to the important role of independent directors. Specific new provisions which were designed to assure their independence and strengthen the independent checks on management were adopted.[9]

For example, Congress added Section 2(a)(19) defining the term "interested person" and substituted that new broader concept for the term "affiliated person" as used in Section 10, which requires at least 40 percent of each fund's board to be disinterested persons. It also amended Section 15 of the Act governing ratification of advisory (management) and underwriting contracts by the board, to require approval "by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party. . . ." Congress also reinforced the statutory role of independent fund directors by amending Section 36. The Senate Report stated:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969).

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[9] *See, e.g.*, Part E: Strengthening Independent Checks on Investment Company Management, S. Rep. No. 91-184, 91st Cong., 1st Sess. 32-34 (1969) (discussing amendments to Sections 2(a), 10, 15 and 32(a) adding the term "interested person").

Thus, it is clear that independent directors of mutual funds were intended by Congress to have a significant measure of authority and responsibility in the exercise of their business judgment in such sensitive areas as approval of management and underwriting contracts.[10] There is no basis in the statute, express or implied, for precluding the exercise of such judgment by independent directors in the area of fund litigation, when the exercise of discretion is permitted—indeed mandated—in much more sensitive areas of greater consequence to the operations of mutual funds.

Nor, prior to the Court of Appeals decision in this case, have the courts interpreted the Investment Company Act to restrict the role of the independent directors in this fashion. To the contrary, the cases arising under the Act—in the Second Circuit itself as well as in other Circuits—make clear that the decision below severely undercuts the purposes of the statute and, in particular, the amendments passed by Congress in 1970.

Thus, in *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), the First Circuit refused to permit a shareholder derivative action on behalf of a mutual fund, where the shareholder had not initially made a demand

[10] Where Congress determined *not* to allow independent directors to exercise their business discretion in a normal fashion, it knew how to do so expressly. For example, contrary to state business corporation practices, under Section 17 of the Act a disinterested quorum of directors is not empowered to authorize or ratify certain specified insider transactions, regardless of disclosure, fairness or reasonableness. Instead, Section 17(b) provides that a proposed insider transaction must be submitted in advance to the SEC, which may grant an exemption if it determines the transaction to be fair and reasonable.

upon the independent directors. The court affirmed the primacy of the determinations of independent directors in the area of litigation, stating:

> "All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim,' it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response. To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." *Id.,* 479 F.2d at 266-67 (citations omitted).

As the *Kauffman* court explained:

> "We recognize the social desirability of bona fide, well founded minority suits. We also recognize the tremendous waste involved in suits that are not well founded." *Id.,* 479 F.2d at 267.

See also Moses v. *Burgin,* 445 F.2d 369 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

The decision below is also inconsistent with the Second Circuit's own determination in *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir.), *cert. denied,* 98 S. Ct. 421 (1977), which sustained the validity of the exercise of the sound business judgment of independent directors with respect to the issue of whether mutual funds need in all circumstances seek to "recapture" brokerage commissions. There, the Court of Appeals for the Second Circuit stated:

> "We have found nothing in the structure or legislative history of the Investment Company Act

> which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors." *Id.*, 552 F.2d at 417.

The court in *Tannenbaum* concluded:

> "Thus the decision to forego recapture here did not violate the fiduciary obligations of either the Fund's adviser or directors under section 36 of the Investment Company Act if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors." *Id.*, 552 F.2d at 418-19 (footnote omitted).

See also Fogel v. *Chestnutt,* 533 F.2d 731, 750 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976).

Indeed, the fundamental premise of the Court of Appeals decision in this case has already been questioned by at least one District Court: "To the extent that *Lasker* assumes the independent directors to be captive to the will of the interested directors, this court disagrees." *Untermeyer* v. *Fidelity Daily Income Trust,* No. 76-1802, slip op. at 30 (D. Mass. May 4, 1978).

ICI respectfully submits that the conflicting decisions in *Kauffman* and *Tannenbaum,* on the one hand, and in this case, on the other, have left the standard of authority and duties of independent mutual fund

directors in a state of serious disarray, and that this conflict should be resolved by this Court before it spawns judicial error and needless litigation for years to come in regard to the important statutory questions involved.

VIII. CONCLUSION

For the foregoing reasons, a writ of certiorari should issue to review the judgment of the Court of Appeals below upon plenary briefing and argument.

Respectfully submitted,

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*,
Petitioners,

v.

HOWARD M. LASKER, *et ano.*,
Respondents.

BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

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June 9, 1978

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BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE* IN SUPPORT OF THE PETITION FOR A WRIT OF CERTIORARI

Investors Diversified Services, Inc. ("IDS"), files this brief as *amicus curiae* with the consent of all parties, urging that the Petition for a Writ of Certiorari be granted. The decision of the Court of Appeals for the Second Circuit below is of substantial concern to IDS, the investment adviser to the nation's largest mutual fund complex.[1] The decision held as a matter of law that a quorum of investment company (mutual fund) independent directors may not terminate shareholder derivative litigation, allegedly brought for the corporation's benefit, despite such quorum's unanimous determination

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[1] IDS is the investment adviser to ten open-end mutual funds. IDS-associated mutual funds have assets exceeding $5 billion, held on behalf of over one million shareholder accounts.

that prosecuting the action would not be in the best interests of the fund. At the very least, this decision places mutual funds in a uniquely disadvantageous position when their independent directors attempt to decide such questions in the best interests of all of their shareholders.

The issues discussed in Parts I and II herein did not receive extended consideration by the Court of Appeals. The District Court upheld the powers of independent mutual fund directors to dispose of shareholder derivative claims, but the Court of Appeals elected to reverse on grounds which were, at least in part, significantly different from those urged by the shareholder-plaintiffs (respondents herein). Thus, the impact of the reasoning employed by the court below was largely unanticipated.

In this brief, IDS seeks to bring to the Court's attention the pervasive ramifications of the decision below to the mutual fund industry and to the federal court system, and to emphasize that a resolution of now-conflicting applications of rules for corporate governance is of critical importance to the functioning of the entire mutual fund industry, and indeed to corporations generally.

Opinions Below

The opinion of the Court of Appeals, *Lasker* v. *Burks,* is reported at 567 F.2d 1208 (2nd Cir. 1978). The opinion appears at page 24a, *et seq.,* of the Appendix to Petition for a Writ of Certiorari ("Petitioners' Appendix") filed by Harry G. Burks, Jr., *et al.* ("Petitioners"). Also set forth in the Petitioners' Appendix, at pages 1a and 14a, respectively, are the opinions of the United States District Court for the Southern District of New York dated

October 17, 1975 (as amended), reported at 404 F.Supp. 1172, and January 7, 1977, reported at 426 F.Supp. 844.

Questions Presented

1. Whether the federal policy respecting mutual funds as expressed in the Investment Company Act preempts long-established state corporation law authorizing independent directors to determine whether the maintenance of a shareholder derivative action is in the best interests of the corporation.

2. Whether the policies embodied in Rule 23.1 of the Federal Rules of Civil Procedure requiring a shareholder who seeks to sue derivatively to exhaust his intracorporate remedies should be abrogated by a judicially-created irrebutable presumption, which cannot logically be confined to the mutual fund context, that the independent members of a mutual fund board of directors can never fairly evaluate a possible claim against the other directors.

3. Whether the independent members of the board of directors of a mutual fund, whose presence on such board is specifically mandated by the Investment Company Act so that they may serve as "watchdogs" for the interests of the fund and its shareholders, should be under any special disability in deciding whether or not the fund's best interests are served by pursuing derivative claims brought by a shareholder allegedly for the fund's benefit.

Rules and Statutes Involved

The statutes and rules involved in this case are the Delaware General Corporation Law, 8 Del. Code §§ 141(a) and (b) (1974), sections 36(a) and (b) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-

35(a) and (b) (1970), and Rule 23.1 of the Federal Rules of Civil Procedure. These statutes and rules are set forth in full in Appendix A hereto.

Statement of the Case

Fundamental Investors, Inc. ("Fundamental"), was chartered as a corporation by the State of Delaware on October 17, 1932 for the purpose of engaging in the mutual fund business. By 1969, Fundamental had over 90,000 shareholders and a portfolio of approximately $1 billion. On November 26, 1969 it purchased, as a short-term investment, $20 million of 270-day notes issued by the Penn Central Transportation Company. Because of Penn Central's bankruptcy in June, 1970, the notes were not paid at their maturity.

The notes had been sold to Fundamental by Goldman, Sachs & Co. ("Goldman, Sachs"), a leading commercial paper dealer. On November 4, 1970 Fundamental brought suit against Goldman, Sachs, claiming that it had violated various anti-fraud provisions of the federal securities laws, and seeking rescission of the Penn Central note transaction.

In early 1973, more than three years after Fundamental had purchased the Penn Central notes, two of Fundamental's more than 90,000 shareholders (hereinafter "respondents") commenced the instant derivative action, allegedly on behalf of and for the benefit of Fundamental, without making a demand upon the directors. Named as defendants were Fundamental, its investment adviser, and all of Fundamental's ten directors serving in 1969 when the notes were purchased.

The complaint sought damages for the defendants' alleged violation of §§ 13(a)(3) and 36 of the Investment Company Act of 1940 (15 U.S.C. §§ 80a-13(a)(3) and 80a-35), and § 206 of the Investment Advisers Act (15 U.S.C. § 80b-6). It also alleged that certain defendants breached common law fiduciary duties and the investment advisory contract. The principal thrust of the factual allegations was that the investment adviser made an insufficient examination of Penn Central's financial condition prior to purchase of the notes. Further proceedings in the action were stayed by the District Court pending resolution of Fundamental's lawsuit against Goldman, Sachs.

On July 9, 1974, after completion of discovery and one day before the scheduled commencement of trial, Fundamental settled its claims against Goldman, Sachs. Goldman, Sachs took back the Penn Central notes, paid Fundamental $5.25 million in cash, and assigned to Fundamental a 73.75% interest in the proceeds of the notes in the Penn Central reorganization proceedings.[2]

At its next regular meeting after settlement with Goldman, Sachs, Fundamental's board reviewed the status of respondents' suit. The board decided that the five directors who were not named as defendants[3] would act as a quorum of the board, pursuant to Section 141 of the

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[2] On March 9, 1978, the United States District Court for the Eastern District of Pennsylvania preliminarily approved a Penn Central plan of reorganization, *see*, The Wall Street Journal, March 10, 1978, at 37 col. 1.

[3] Five of Fundamental's directors assumed office after the purchase of the Penn Central notes, and were thus not named as defendants. Louis F. Laun was elected in 1971, Mary S. O'Connor in 1972, Dr. Beryl Robichaud and William J. Stephens in 1973, and Leon T. Kendall in 1974. *See*, Petition for a Writ of Certiorari, at 5,n.*.

Delaware General Corporation Law and Fundamental's Bylaws, to determine what position Fundamental should take regarding this action. These five directors (hereinafter the "independent directors") were all statutorily disinterested persons under the Investment Company Act (15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a)), were not directors at the time of the events complained of, and were not affiliated in any way with Fundamental's investment adviser. The remaining directors agreed to take no part whatsoever in the independent directors' determination.

On July 24, 1974, the independent directors retained special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to advise them concerning Fundamental's possible claims against its investment adviser and the other defendants. Special counsel had no previous connection with any of the parties. Special counsel studied respondents' complaint, the proceedings in the action against Goldman, Sachs, and the files of Fundamental and its investment adviser relating to the Penn Central note transaction; he interviewed officers and employees of Fundamental and the adviser; and he analyzed the facts and the law. On December 5, 1974, special counsel reported to the independent directors in a comprehensive 40-page legal and factual memorandum, concluding that there was no violation by the defendants herein of any statutory, common law or contractual duty to Fundamental.

The independent directors met, reviewed the subjects raised by special counsel's memorandum, discussed the various alternatives open to Fundamental, and posed additional questions to special counsel. He then sent a

supplemental memorandum to the independent directors on December 18, 1974, pointing out that whether or not the claims were to be enforced in the courts was, like other matters concerning the corporation's best interests, properly committed to the discretionary business judgment of the independent directors.

The independent directors then held a series of discussions and special meetings to consider special counsel's memoranda. On January 6, 1975, they unanimously determined that prosecution of respondents' suit was contrary to the best interests of Fundamental and its shareholders (other than the two respondents). The factors relied upon by the independent directors included the dim prospects of recovering from any defendant amounts beyond those already paid by Goldman, Sachs; special counsel's opinion that there was no merit to the claims and little likelihood of success; the substantial litigation expense to Fundamental; and the major disruption of Fundamental's affairs which would accompany litigation, including the probability that Fundamental would have to replace its investment adviser. See, 404 F.Supp., at 1176-77 (S.D.N.Y. 1975; Werker, J.).

On instructions from the independent directors, litigation counsel for Fundamental thereafter moved to dismiss respondents' action as not being in the best interests of the corporation. The District Court held that Fundamental's board had complete power under the business judgment rule to bar prosecution of this action if the directors who made the decision were truly disinterested and independent. *Id.*, at 1180.

Because respondents made a factual issue of whether the quorum of five directors was disinterested and independent, the District Court directed further proceedings related solely to that issue. After exhaustive discovery on this question, on January 7, 1977 the court granted Fundamental's motion to dismiss. The court found that the respondents "have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently." 426 F.Supp. 844, 849 (S.D.N.Y. 1977).

Respondents appealed to the Court of Appeals for the Second Circuit. On January 11, 1978, that court reversed, holding that the independent directors were not entitled to terminate respondents' derivative action. A petition for rehearing in banc was denied on March 9, 1978.

Summary of Argument

The decision of the Court of Appeals for the Second Circuit in the case at bar incorrectly disregarded controlling principles of state corporate governance law. The court below held, *as a matter of law,* that a quorum of mutual fund directors found by the District Court to be "truly independent" was disqualified from deciding to terminate a shareholder derivative suit, allegedly brought for the corporation's benefit, which it had determined was not in the best interests of the corporation, despite the fact that the independent directors who comprised the quorum made such determination in "good faith" after extensive consultation with independent special counsel.

There is a well-settled principle of state law, generally referred to as the business judgment rule, which places the responsibility for the management of a corporation—including decisions as to whether or not to pursue a possible corporate claim through litigation—in the hands of independent directors duly elected by the corporation's shareholders. The District Court honored this principle, but the Court of Appeals regarded it as irrelevant. The result reached below, if applied generally, threatens the basic structure of intra-corporate governance by permitting two recalcitrant shareholders among 90,000 to impose their will upon the corporation by continuing to maintain this litigation, ostensibly on behalf of the corporation, in spite of the informed opposition of the independent directors who assessed the proposed claims.

Although the Court of Appeals purported to find support for this extraordinary result in the fact that respondents were presenting claims involving federal policies, such a basis for ignoring state corporate governance law is clearly inconsistent with a long line of decisions of this Court. The most recent such decision, *Santa Fe Industries, Inc. v. Green,* 430 U.S. 462, 479 (1977), holds that such state law will be displaced only when federal law "expressly" requires it—a test not satisfied here.

The Court of Appeals also buttressed its decision to ignore settled state law by creating an irrebuttable presumption of law that the independent members of a board of directors are incapable of passing fairly upon proposed corporate claims directed in part at their fellow directors, 567 F. 2d, at 1212, and by referring to "the unique nature

of the investment company and its symbiotic relationship with its investment adviser." *Id.*, at 1212, n.14. Neither of these rationales withstands analysis.

The presumption employed by the Court of Appeals to ignore the independent directors' decision cannot logically be confined to corporations which happen to be mutual funds. Thus, unless reversed, it has the potential to greatly expand shareholder derivative litigation (involving both mutual funds and other public corporations) in the federal courts by rewriting Rule 23.1 of the Federal Rules of Civil Procedure so as to eliminate, for all practical purposes, the requirement of a demand on directors prior to the commencement of derivative litigation. Since shareholder derivative plaintiffs will, on this analysis, now be able to maintain suits in spite of the opposition of an independent quorum of the board, the decision below reverses the traditional preference for corporate rather than judicial determination of whether or not to sue on proposed corporate claims.

Finally, to the extent that the Court of Appeals sought support for its decision in the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, it drew from the legislative materials precisely the opposite conclusion from that intended by Congress, which has attempted to enhance and strengthen the role of mutual fund independent directors as "watchdogs" for the interests of all shareholders. The decision below conflicts not only with Congressional intent, but also with a leading decision of the Court of Appeals for the First Circuit and previous decisions in the Second Circuit which have consistently interpreted the Investment Company Act to uphold the right and duty of mutual fund independent directors to determine whether the pursuit of shareholder derivative

claims is in the best interests of the fund. If allowed to stand, the decision below significantly limits the opportunity of such directors to exercise their responsibility in an important area of mutual fund management.

REASONS FOR GRANTING THE WRIT

I. The Decision of the Court of Appeals Preempts State Law Corporate Governance Principles in Violation of Numerous Decisions of this Court

It has long been a settled tenet of corporate law that the board of directors has the responsibility and duty, imposed by the chartering state, to run the corporation. This principle is fundamentally democratic: since directors are elected by vote of all of the shareholders for the very purpose of deciding where the best interests of the corporation lie, their business judgment may not ordinarily be questioned in the courts at the behest of a single shareholder. *Hawes* v. *Oakland*, 104 U.S. 450 (1881); 2 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 505, 528 and 535 (1969 ed.).

The business judgment rule is particularly important in the area of directors' control over corporate assets, including the disposition of possible corporate claims. This Court emphasized in *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903), that:

> "[A] court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an

act which their judgment does not approve, or to substitute his judgment for theirs."

This organizational structure in which directors rather than shareholders are charged with running the affairs of a corporation is a creation of state, not federal, law. Corporations in fact owe their very existence to state law.[4] Fundamental—the corporation whose interests are the only ones in issue in this case—is a Delaware corporation, deriving such powers as it possesses under its Certificate of Incorporation and Bylaws directly from the Delaware General Corporation Law.

Under Delaware law, independent directors (such as the five who acted here), rather than one or more of the corporation's shareholders, are charged with the responsibility for, and have complete powers of disposition over, claims by and against the corporation.[5] The Delaware courts have repeatedly held that a good faith exercise of business judgment by a corporation's board of directors—including decisions whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit.[6]

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[4] Recent proposals for the federal chartering of corporations, see *e.g.*, Nader, et. al., *Constitutionalizing the Corporation: The Case for the Federal Chartering of Giant Corporations* (1976), have not resulted in new federal statutes.

[5] Delaware Code, Title 8, § 141 (1975); *see also, Cohen* v. *Beneficial Loan Corp.*, 337 U.S. 541, 549 (1948); *Davis* v. *Louisville Gas & Electric Co.*, 16 Del. Ch. 157, 142 A. 654 (1928).

[6] *See e.g., McKee* v. *Rogers*, 18 Del. Ch. 81, 156 A. 191 (1931); *Ella M. Kelly & Wyndham, Inc.* v. *Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz* v. *Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (1963); *Beard* v. *Elster*, 39 Del. Ch. 153, 165, 160 A.2d 731, 738-9 (1960); *Puma* v. *Marriott*, 283 A.2d 693, 696 (Del. Ch. 1971). This rule is one of general application under the corporation laws of most if not all jurisdictions. *See, Swanson* v. *Traer*, 249 F.2d 854 (7th Cir. 1957).

Only in limited circumstances may shareholders bring suit derivatively to redress harm done the corporation. Because such suits may not be consistent with the best interests of all shareholders and may be abused,[7] several significant limitations have been imposed on derivative litigation. One of the most important is the requirement that a dissident shareholder exhaust intra-corporate remedies. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U.Chi.L.Rev. 168 (1976). The exhaustion requirement is implemented by imposing a duty on the shareholder to make a demand on the directors to sue on his proposed claim, or to demonstrate why such a demand would be futile.[8] If the directors conclude not to sue, their decision will be tested under the business judgment rule and will be final unless the shareholder can demonstrate that the board has wrongfully refused to pursue a proposed cause of action on behalf of the corporation.[9]

This established state-law framework has been rejected, at least insofar as corporations which are mutual funds are concerned, by the decision of the court below, which permits two shareholders to substitute their judgment for that of a quorum of its directors determined by the District Court to be "truly disinterested and independent." 426 F.Supp., at 847. The Court of Appeals' decision

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[7] *See, Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 739-41 (1975).

[8] *See, e.g.*, Rule 23.1 of the Federal Rules of Civil Procedure; Delaware Chancery Court Rule, Rule 23.1. The historical background of Rule 23.1 is summarized in *Heit* v. *Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977).

[9] Comment, *supra*, 44 U.Chi.L.Rev., at 193-98; *City of Detroit* v. *Dean*, 106 U.S. 537, 541-42 (1882); *McKee* v. *Rogers*, *supra*.

requires a trial herein, notwithstanding the independent directors' informed judgment that the case is not in the corporation's best interests.[10]

The Court of Appeals erroneously believed that it was empowered to disregard state corporate governance law because the shareholders' claims were, at least in part, based on alleged violations of federal policies as set forth in the Investment Company Act. This holding disregards a long and remarkably uniform series of decisions by this Court that shareholders cannot wrest from the directors control of the prosecution of claims brought on the corporation's behalf in the federal courts.[11]

In *Price* v. *Gurney*, 324 U.S. 100 (1945), corporate security holders filed a derivative petition alleging, as do the respondents here, that the pervasive policy embodied in a federal statute (the Bankruptcy Act) permitted them to override the business judgment of the board of directors and maintain an action for the corporation's benefit without directorial consent. This argument was quickly rejected:

> "[N]owhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation. Respondents may have a meritorious case for relief. On that we intimate no opinion. But if they are to be allowed to put their corporation into bankruptcy, they must present credentials to the bankruptcy court showing their authority." 324 U.S., at 107.

[10] The reasons why the directors determined not to pursue the claims proposed by respondents are summarized *supra* at p.7.

[11] The Court of Appeals' decision acknowledged the primacy of Delaware law as determinative of most questions regarding the independent directors' actions herein, but ignored this controlling body of law in passing upon the business judgment issue which was presented, *see* 567 F.2d, at 1210, n.5. *Cf., Untermeyer* v. *Fidelity Daily Income Trust*, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,419 at 93,513, n.17 (D. Mass., May 4, 1978).

There are, of course, certain areas of substantive law where under the Supremacy Clause federal law preempts state law. The court below evidently presumed that it was empowered to ignore state corporate law because a federal policy in favor of protecting mutual fund investors permitted it. However, until the decision below there has never been the slightest suggestion that state law control of intra-corporate decision-making is susceptible to federal preemption, no matter how "strong" a federal policy is involved.

The federal policy underlying the antitrust laws is so strong that the Sherman Act has been characterized as "the Magna Carta of free enterprise." *U.S.* v. *Topco Associates, Inc.*, 405 U.S. 596, 610 (1972). Yet even this fundamental federal policy does not displace the business judgment rule when a shareholder seeks to assert derivatively a corporate antitrust claim over directorial opposition. In *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917), this Court flatly rejected a shareholder attempt to bring a treble-damage action on behalf of a corporation after its directors had declined to institute suit. In response to the same argument advanced by respondents below—that federal policy would be

thwarted unless the corporation's business judgment was overridden—Justice Brandeis held that:

> "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation." 244 U.S., at 264.

The principle set forth in *Price* and *United Copper* has been unwaveringly followed by this Court. *See, Cort* v. *Ash,* 422 U.S. 66 (1975).[12] Indeed, even in the area of federal regulation of transactions in securities this Court has refused to allow interference with state laws of corporate governance. In *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977), this Court refused to allow a shareholder to maintain a derivative action raising federal securities antifraud claims (analogous to those raised by respondents here) on behalf of a corporation involved in a Delaware statutory short-form merger. Reiterating its

[12] In *Cort* v. *Ash,* this Court was faced with a shareholder derivative claim bottomed upon as intrinsic a federal concern as the integrity of federal elections under the Federal Election Campaign Act. There, as here, the shareholder, complaining of supposed federal statutory violations, asserted the right to maintain his damage action for the corporation's benefit. Justice Brennan, writing for a unanimous court, stated that:

> "[A private cause of action by a stockholder to secure derivative damage relief] is available, if at all, under Delaware law governing corporations.
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> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation. . . . We are necessarily reluctant to imply a federal right to recover funds used in violation of a federal statute where the laws governing the corporation may put a shareholder on notice that there may be no such recovery." 422 U.S., at 77-78, 84-85 (footnote omitted).

earlier holding in *Cort v. Ash, supra,* the Court stated in *Santa Fe* that:

> "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." 430 U.S., at 479.

This Court has thus consistently refused to disturb the state law axiom of corporate governance that independent and disinterested corporate directors have the final responsibility and obligation to determine the course of action which is in the corporation's best interests. The business judgment rule defeats attempts by shareholders to sue over the directors' objection, and fully applies whether the claim sought to be asserted relates to some federal policy or not.

The court below was cognizant of the foregoing authority, but nevertheless concluded that "the plethora of cases . . . dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite." 567 F.2d, at 1212, n. 14. It offered two reasons for its decision to disregard these principles. The first was an irrebuttable legal presumption (based largely upon subjective psychological factors) that the independent directors were here disqualified from exercising their business judgment because they could not pass fairly on a claim directed in part at some of their fellow directors. Since the independent directors "must constantly deal with majority directors in a spirit of accommodation,"

since they must "rely on the information and expert advice provided by the adviser and the majority directors," and since their continued service and receipt of directors' fees "depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection," the court below stated that:

> "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." *Id.,* at 1212.

The second reason offered was "the unique nature of the investment company and its symbiotic relationship with its investment adviser," *id.,* at 1212, n.14, which the Court of Appeals discerned from a selection of previous mutual fund decisions and the federal statutory framework regulating certain mutual fund activities.

We submit that neither reason provides sufficient basis for a decision which is incompatible with this Court's prior decisions in *Price, United Copper, Cort,* and *Santa Fe.* Those decisions require compliance with state law concerning corporate governance. In Parts II and III, below, we examine both of these reasons in greater detail and demonstrate that they are themselves unsound as a matter of law, policy, and logic.

II. The Decision of the Court of Appeals Threatens to Expand Greatly Shareholder Derivative Litigation in the Federal Courts.

We have described above the legal rules governing the relationship between a corporation's board of directors and shareholders who wish to sue derivatively on behalf of the corporation. We have also outlined the irrebuttable legal presumption which the court below created to sweep aside that body of law as irrelevant to its decision. That presumption, which cannot logically be confined to mutual funds, has the potential to greatly increase the burden of shareholder derivative suits in the federal courts, since it conflicts with well established doctrines specifically embodied in Rule 23.1 of the Federal Rules of Civil Procedure, and cases construing that Rule, designed to insure that shareholders exhaust their intra-corporate remedies before commencing suit in the federal courts. Rule 23.1 requires that a shareholder wishing to sue derivatively must allege with "particularity" the effort made to obtain the desired action from the board of directors or the reasons for not making such an effort.[13]

In the present case, respondents sought to satisfy Rule 23.1 by alleging in their complaint that no demand on Fundamental's directors was made:

> ". . . because the Fund's Board of Directors is dominated and controlled by the Adviser and the

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[13] Rule 23.1, Fed. R. Civ. P., entitled "Derivative Actions by Shareholders," provides in pertinent part:

> "In a derivative action brought by one or more shareholders . . . to enforce a right of a corporation . . ., the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and, if necessary, from the shareholders . . . , and the reasons for his failure to obtain the action or for not making the effort. . . ."

individual defendants continue to be a majority of the Fund's Board of Directors and they have participated, cooperated and aided and abetted in the wrongful acts, transactions and delinquencies complained of. No action could or would be permitted to be instituted by the Fund without the consent of the Fund directors. The Fund's Board of Directors for a considerable time has been fully aware of the wrongful acts herein alleged and has nevertheless failed to take action. Consequently, any demand upon the Fund's Board of Directors would be futile and useless and any such action that would be instituted by the Board of Directors on behalf of the Fund would be friendly to the defendants, would not be diligently prosecuted and would be hostile to the interests of the Fund and its stockholders." Complaint, ¶7(a).

Faced with such a complaint, Fundamental's board had two options that would allow it to fulfull its obligations to all of the shareholders: (1) to attack the sufficiency of these allegations by means of a motion to dismiss for failure to satisfy Rule 23.1; or (2) to proceed, through the quorum of independent directors, to assess the wisdom of the proposed claims as though a demand had been made. Either option, if successful, would provide the independent directors an opportunity to review the proposed suit in light of Fundamental's best interests. The board chose the second option.

A motion to dismiss attacking the sufficiency of respondents' Rule 23.1 allegations would have presented several distinct problems, not the least of which is the

widely varying judicial attitude concerning the Rule itself.[14] Indeed, some courts have acknowledged that there is a conflict in the circuits concerning the standards applied to such motions. As the Court of Appeals for the First Circuit recently stated in *Heit* v. *Baird*, 567 F.2d 1157, 1160 (1st Cir. 1977):

> "Courts have tended to vary in the rigor with which they enforce Rule 23.1, *see*, Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv.L.Rev. 746, 747 (1960); in this circuit, the rule has been vigorously enforced. We said in [*In re*] *Kauffman* [*Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973),] that this requirement both continues a long tradition in the federal courts previously codified as Equity Rules 93 and, later 27, and represents a deliberate departure from the relaxed policy of 'notice' pleading promoted elsewhere in the Federal Rules. The requirement places an initial burden on the stockholder 'to demonstrate why the directors are incapable of doing their duty,' *id.* at 263, and failure to meet this burden requires dismissal of the suit."[15]

[14] Professor Moore has observed that "[t]here is no unanimity of opinion amongst the courts, and probably the most straight-forward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand." 3B Moore's Federal Practice, ¶ 23.1.19, at p. 23.1-83 (2d ed. 1975).

[15] *Compare, Kauffman* and *Heit with, deHaas* v. *Empire Petroleum Co.* 286 F. Supp. 809 (D. Col. 1968), *aff'd*, 435 F.2d 1223, 1228 (10th Cir. 1970) ("[c]ourts have generally been lenient in excusing demand"). *See also, Untermeyer*, n.11, *supra*.

Despite this and other problems,[16] dismissal motions grounded upon Rule 23.1 have been successful in instances where: (1) a majority of the board of a corporation was not shown to be disabled from passing on the question presented;[17] or (2) the composition of the board had changed significantly between the time either when the cause of action arose, when a previous demand was rejected, or when a complaint was filed, and the time of moving for dismissal.[18] Such a motion should also be

[16] There is also a split of authority concerning whether it is proper to consider affidavits in deciding such a motion. *See*, cases cited in Comment, *supra*, 44 U.Chi.L.Rev., at 181, n. 90. Affidavits setting forth uncontested facts concerning the membership of the board over time and directors' backgrounds may be critical for an accurate response to broad, conclusory allegations—such as respondents used here—designed to show that the board is disabled from fairly considering whether to pursue a proposed claim. *See, e.g. Baffino* v. *Bradford*, 57 F.R.D. 79 (D.Minn. 1972), where Chief Judge Devitt considered affidavits concerning the independence of directors prior to dismissing the complaint for failure to make a demand.

[17] *Kauffman, supra*, 479 F.2d at 264; *Heit, supra*, 567 F.2d, at 1161; *Abrams* v. *Mayflower Investors, Inc.*, 62 F.R.D. 361, 368-70 (N.D. Ill. 1974); *Lerman* v. *ITB Management Corporation*, 58 F.R.D. 153, 156-59 (D.Mass. 1972). *See also, Untermeyer, supra*, at 93,512-13 (board evenly divided between interested and independent directors).

[18] *Brody* v. *Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973), *on remand*, 66 F.R.D. 87, 89 (S.D.N.Y. 1974), *aff'd* 517 F.2d 932, 934 (2d Cir. 1975); *Independent Investor Protective League* v. *Saunders*, 64 F.R.D. 564, 570-71 (E.D.Pa. 1974); *see also, Corey* v. *Independent Ice Co.*, 207 F. 459, 464 (D.Mass. 1913) (complaint alleging demand on directors nineteen months before filing suit should also allege that the same directors were presently in office to comply with the demand requirement); 7A C. Wright and A. Miller, Federal Practice and Procedure: Civil § 1831, at 377-78 (1972 ed.) ("if a substantial period has transpired between the demand and the institution of the action, the court may insist on a second demand or proof that the directors or the nature of the claim have not changed"); 3B Moore's Federal Practice, ¶23.1.19, at 23.1-81-82 (1976 ed.) ("From the particular facts alleged, it must appear that a new board of directors has not been installed. . . . [A] shareholder's suit is to be resorted to as a last alternative, and . . . the corporation is given every possibility to sue in its own name").

available whenever, under the applicable state law, a quorum of independent directors exists to pass upon the shareholder's demand.[19] Analytically there is no distinction between such a case—presented here—and the situation presented in *Heit, supra,* where a derivative complaint was dismissed for failure to show that a majority of the board was disqualified from passing fairly upon plaintiff's proposed claim. Moreover, the current trend in corporate governance away from having a corporate board consisting solely of present officers or employees of that corporation supplies a major impetus for sustaining the practice of allowing an independent quorum of directors to pass upon a demand.[20]

[19] *See, e.g., Gall* v. *Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976); *Auerbach* v. *Bennett*, N.Y. Law Journal, May 10, 1977, p.14 col. 6 (Sup. Ct., West. Co.). Had respondents thereafter sought to dispute the independence of the deciding directors, the most expeditious means of proceeding would have been to grant limited discovery and a separate trial under Rule 42(b) of the Federal Rules of Civil Procedure on the *bona fides* (*i.e.*, the independence) of the quorum of directors who decided the issue. Comment, *supra*, 44 U.Chi.L.Rev., at 198-200; *cf., Wallenstein* v. *Warner*, N.Y. Law Journal, May 9, 1978, p. 11 col. 3 (Sup. Ct., N.Y. Co.). Such a result, of course, would not differ in substance from the procedure District Judge Werker employed in this case.

[20] This trend has been summarized as follows:

"The Conference Board's Jeremy Bacon confirms that his research over the years has shown a steady increase in the number of manufacturing companies having a majority of outside directors [—those who are not salaried employees of the corporation and who are not involved in day-to-day staff or operating decisions—] on their boards. In 1967 this figure was 63% of the companies studied; in 1973, 71%. The 1976 figure reflects that 83% of the nearly 300 companies studied had such an outside majority.

"A separate analysis of 175 leading corporations (made by my own office) showed 86% with a majority of outsiders, 10% with a minority, and the 4% balance having equal representation of outsiders and insiders. Both my study and that of the

Fundamental's selection of the second available option seems clearly preferable. First, this approach subjects the proposed cause of action to non-judicial but nevertheless independent review on the merits sooner than would be the case if trial were the only alternative.[21] Prompt review of the facts by independent counsel, before memories fade, witnesses die, or evidence is lost, is always useful, particularly where, as here, respondents' complaint was not filed until more than three years after the challenged transactions took place. Second, it permits an evaluation by the independent directors—again at a relatively early stage—of the full range of factors which the courts have repeatedly held are relevant in applying the business judgment rule. Finally, this approach saves the judicial and corporate time and expense attending a dismissal motion based on Rule 23.1 which, even if successful, might still have been followed by proceedings directed at the *bona fides* of the independent directors who passed upon the subsequent demand.

The thrust of respondents' argument below was that many of the business judgment cases discussed herein were inapplicable because they were cases in which a board of directors, after receiving a demand, chose not to

Conference Board confirm that the number of outside directors tends to rise with the size of the company, its complexity, and the extent of its international involvements."

Estes, *The Emerging Solution to Corporate Governance*, 55 Harvard Bus. Rev. 20, 21-22 (Nov.-Dec. 1977).

[21] The case law is clear that the other members of the board, and corporate management, are under a duty to provide the independent directors and their counsel with complete and accurate information upon which to base their decision. *See, e.g., Moses* v. *Burgin*, 445 F.2d 369, 376 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971); *Tannenbaum* v. *Zeller*, 552 F.2d 402, 417 (2d Cir.), *cert. denied*, 98 S. Ct. 421 (1977); *Fogel* v. *Chestnutt*, 533 F.2d 731, 745 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976).

pursue a cause of action proposed by a shareholder, or the shareholder-plaintiff contended that Rule 23.1 demand was excused. Since Fundamental did not attack the complaint on Rule 23.1 grounds, respondents characterized this case as one which was "validly commenced." Respondent's Br., at pp. 27-33, and Reply Br., p. 1, 2d Cir. But that argument, we submit, begs the question.

If the argument is correct, it follows that the *only* opportunity that the independent members of a corporate board will have to pass on whether a proposed cause of action is in the corporation's best interests is if the putative plaintiffs and their counsel are so careless as to make a demand of the board before filing suit. Such a result is inconsistent with the cases discussed above, and with the spirit of Rule 23.1.[22]

Since the demand requirement and the business judgment rule are closely intertwined,[23] the procedural course of action followed by Fundamental should not materially affect whether directorial control of litigation is to be upheld when the deciding directors are truly independent. The court below could have helped to assure such a result by approving the careful course of action followed by the District Court. The central benefit that follows should be fair resolution of more of these disputes within the structure of the corporation itself. The courts would remain available—as they should be—for the

[22] See the discussion at *supra*, pp. 22-23, and accompanying footnotes.

[23] 7A C. Wright & A. Miller, *Federal Practice and Procedure: Civil* § 1832 (1972 ed.); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv.L.Rev. 746, 759 (1960).

limited purpose of testing the independence of the deciding directors.

However, the court below substituted an irrebuttable legal presumption that independent directors of a mutual fund board cannot function independently when considering proposed claims against some of their colleagues on the board, in place of a factual examination of that limited issue where necessary in particular cases. Although it set out several bases for its presumption as to "human nature", the court clearly did not believe that an independent minority of board members—even one constituting over 40% of the board—could ever pass fairly upon proposed corporate claims directed in part at fellow directors.[24] The Court of Appeals expressly stated that it was "unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent," and that it had no doubt that "the five minority directors acted in good faith." 567 F.2d, at 1212.

There is nothing in the court's presumption, or in the assumptions as to "human nature" upon which it is based, that confines its application to corporations which happen to be mutual funds. Thus, the presumption—if applied in future cases to publicly-held corporations generally—would make pointless asking *any* independent director to decide whether to pursue a proposed corporate claim against another director.[25] Moreover, given the presump-

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[24] *See*, the discussion, *supra*, at pp. 13-14.

[25] Indeed, one attorney who frequently represents derivative plaintiffs has stated in discussing the opinion of the court below that: "Despite the Court's reservation, it is difficult to perceive how the relationships and allegiances between the inside and outside directors of a mutual fund that were adverted to by the Court would be different in the case of any other kind of corporation." Bernstein, *Securities-Class Actions*, N.Y. Law Journal, March 22, 1978, at 24, n. 6.

tion, there is no logical distinction between the facts presented here and situations where a board majority (*e.g.*, 60%) is independent. As long as any board member was allegedly involved in the acts complained of, those who were not involved would be under the same presumptive disability to pass fairly on the wisdom of the claims. Rule 23.1 and the policies which it embodies have thus been emasculated, since there is little purpose in requiring a demand on independent directors who are disqualified as a matter of law from exercising their business judgment concerning the corporation's best interests.

The language which the court below used to set forth its presumption can be expected to appear repeatedly, with minor variations, in those portions of innumerable future derivative complaints involving all kinds of public corporations, not merely mutual funds, explaining why demand on the board of directors should be excused. In this sense the court's presumption will serve only to exacerbate the existing conflict in the circuits over the proper interpretation of the demand requirement of Rule 23.1.[26]

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[26] Shareholder derivative suit plaintiffs have already begun citing the opinion of the court below as a basis for opposing dismissal motions based on Rule 23.1. In *Untermeyer, supra*, such a claim was rejected on the strength of *Kauffman* and *Heit, supra*. The district judge noted that, because the opinion below "does not address the requirement of demand on the board of directors, and comments that Rule 23.1 cases are inapposite," *id.*, at 93,513, n. 17, it is not strictly inconsistent with those earlier decisions of the First Circuit. The court, however, went on to expressly reject the presumption employed below: "To the extent that *Lasker* assumes the independent directors to be captive to the will of the interested directors, this court disagrees." *Id.* We question the *Untermeyer* court's attempt to distinguish the opinion below. In our view, application of the presumption to facts such as those in *Kauffman* and *Heit, supra*, where complaints were held deficient because they did not show that majorities of the boards were disabled from exercising their business judgment, would call for different results in those cases.

The Court of Appeals obviously was not entirely comfortable with this result, because it sought to ameliorate the harshness of its new rule by suggesting that it should only apply to "non-frivolous" actions. *Id.* Although it did not specifically define a "non-frivolous" action, the court was apparently referring to that class of case where the court "cannot say that, following a trial on the merits, the defendants would be found free from liability," *id.*, at 1210; in other words, for example, cases where a motion to dismiss for failure to state a claim would be denied.

However, this test only increases the potential for excessive derivative litigation created by the decision below, because it necessarily excludes numerous other business considerations (unrelated to the legal merits of the proposed case) which this and other courts have frequently recognized as appropriate to a prudent decision as to whether or not a corporate claim should be pursued.[27] As this Court stated in *Corbus* v. *Alaska Treadwell Gold Mining Co., supra:*

> "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right." 187 U.S., at 463.[28]

[27] This result conflicts with the Second Circuit's own prior precedent in *Fogel* v. *Chestnutt, supra,* where a different panel of the court stated that the performance of statutory duties by mutual fund independent directors required them to evaluate both "legal difficulties" and "economic pros and cons," 533 F.2d, at 749-50. The importance of non-legal considerations is supported by extensive precedent permitting the weighing of non-legal factors in the decision whether or not to pursue corporate claims. *See, e.g., Bernstein* v. *Mediobanca,* 69 F.R.D. 592, 597 (S.D.N.Y. 1974); *Puma* v. *Marriott, supra; Findley* v. *Garrett,* 109 Cal.App.2d 166, 240 P.2d 421, 426 (1952); *Goodwin* v. *Castleton,* 19 Wash.2d 748, 764, 144 P.2d 725, 733 (1944).

This Court is well aware of the fact that shareholder derivative litigation—although sometimes necessary to vindicate corporate rights—is often abused. The court below, in erecting a "frivolous case" exception as the only escape from its new presumption, has added a powerful new weapon to the arsenal of shareholder's counsel, particularly so if, as we submit, the presumption cannot logically be confined to the mutual fund context. As long as derivative complaints can be drafted so as to avoid motions to dismiss, all such cases will seemingly require a full trial on the merits despite the fact that there is often an independent quorum of directors ready to assess fairly, and with unassailably competent and independent advice from counsel, the proposed case and its effect on the corporation. As this Court recently observed in *Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 742 (1975), once commenced, shareholder derivative litigation is "virtually impossible to dispose of prior to trial other than by settlement."

[28] Protracted stockholder derivative litigation inevitably has a major impact upon a corporation's affairs, and consideration of many factors beyond mere courtroom "non-frivolousness" is thus central to sound exercise of directorial responsibilities and, ultimately, to corporate well-being. Recent litigation in the federal securities law area has amply demonstrated that cases with initially bright prospects may ultimately result in irretrievable dissipation of corporate energies and resources, *compare Mills* v. *The Electric Auto-Lite Co.,* 396 U.S. 375 (1970), *with* 552 F.2d 1239 (7th Cir. 1977). This Court recognized in *Blue Chip Stamps, supra,* at 740, that "[t]he very pendency of [shareholder] lawsuit[s] may frustrate or delay normal business activity of the defendant which is totally unrelated to the lawsuit."

Such a result is unnecessary, and indeed unwise. The District Court's approach in this case, as we urge above, has a far stronger basis in law, policy and logic, for it preserves the right of truly independent directors generally, and independent directors of mutual funds in particular, to resolve internally the question whether a claim should be pursued, while permitting judicial evaluation of the limited issue of the directors' independence. "If a stockholder could compel the officers [of a corporation] to enforce every legal right, courts, instead of the chosen officers, would be the arbiters of the corporation's fate." *Ashwander* v. *Tennessee Valley Authority,* 297 U.S. 288, 343 (1936) (Brandeis, J., concurring). By strengthening the hand of derivative plaintiffs in mutual fund litigation (and, by logical extension, in corporate litigation generally), the court below necessarily has expressed a preference for judicial resolution of such intra-corporate disputes. That result—and the concomitant increase in complex federal court litigation—should be based on firmer footing than the vague presumption relied upon below.

In the concluding section of this brief we show that there is nothing in the framework of statutory and decisional law applicable to mutual funds which supports the creation of such a presumption, even if its effects could somehow be limited to the mutual fund context. Indeed, we demonstrate that the court drew precisely the *opposite* conclusion from that intended by the Investment Company Act, with the result that the opinion below places independent directors of mutual funds under a special disability in attempting to exercise the "watchdog" function expressly intended for them by Congress and confirmed by previous decisions in both the First and Second Circuits.

III. The Opinion Below Creates a Conflict Among the Circuits as to the Duties of Mutual Fund Independent Directors Under the Investment Company Act

The decision below conflicts with prior interpretations of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.,* in both the First and Second Circuits. The interpretation which the court below gave to the Investment Company Act is of critical importance to its decision because the framework of the Act was said to provide one basis for departing from what the court acknowledged was a "plethora" of cases upholding "the powers of boards of directors to terminate stockholder derivative suits." 567 F.2d, at 1212, n. 14.[29]

On more than one occasion the Supreme Court has stated that the *only* circumstance under which it would be willing to uphold interference with the state law of corporate governance is "where federal law expressly requires [it]," *Cort* v. *Ash, supra,* 422 U.S., at 84; *Santa*

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[29] Nine such decisions, including four by this Court, were cited by the District Court, 404 F.Supp., at 1179. The court below also offered as a basis for its decision what it described as "the unique nature of the investment company and its symbiotic relationship with its investment adviser," 567 F.2d, at 1212, n. 14. The link between this observation and the presumption which the court employed was never explained. Although we believe that application of the presumption cannot logically be confined to corporations which happen to be mutual funds, see Point II, *supra,* our position is that, assuming *arguendo* such a limitation exists, the court below erred in the conclusion it drew based on the Investment Company Act of 1940. Moreover, the court failed to examine what significance, if any, such a factor might have under controlling state law. *See,* Point I, *supra.* The District Court had found the controlling law on this question to be that "absent a showing of improper motive they [the independent directors] have always been permitted to apply their business judgment to decisions involving derivative suits against [affiliated] corporations they serve," citing *Warshaw* v. *Calhoun,* 43 Del.Ch. 148, 221 A.2d 487 (1966). *See,* 426 F.Supp., at 849.

Fe Industries, Inc. v. *Green, supra,* 430 U.S., at 479. This Court has never found such a situation to have occurred, and there is clearly no provision of the Investment Company Act, express or otherwise, which satisfies that test. Indeed, the Court of Appeals did precisely what *Santa Fe* directs the federal courts not to do. By sweeping aside "established state policies of corporate regulation" the decision herein would "federalize" a "substantial portion of the law of corporations" in the complete absence of anything even resembling a "clear indication of congressional intent." 430 U.S., at 479.

The statutory provisions relied upon by the court below were those sections of the Investment Company Act which require 40% of the membership of mutual fund boards of directors to be unaffiliated with the fund's investment adviser, 15 U.S.C. §§ 80a-2(a)(3) and (19), 80a-10(a), and which provide for shareholder suits challenging the level of compensation provided for in the investment advisory contract, but seeking no other relief. 15 U.S.C. § 80a-35(b).

But the legislative history of the 1970 amendments to these very sections reveals Congress' intention to strengthen the standards for independence of mutual fund directors not affiliated with the investment adviser through the use of a newly defined term, "interested person." Indeed, the Senate Report accompanying the 1970 amendments reveals that even with respect to the specific issue addressed by the amendments—the level of investment advisory fees set by an adviser's contract with a fund—the new statutory language "is not intended to authorize a court to substitute its business judgment for that of the

mutual fund's board of directors," S.Rep. No. 91-184, 91st Cong., 1st Sess. at 33 (1969), *reprinted in* [1970] U.S. Code Cong. & Admin. News 4897, 4902. Since the legislation relied upon by the court below was plainly intended not to supplant the business judgment rule even in the area of advisory fees, *a fortiori* it can supply no basis for disenfranchising directors from control in other areas. Indeed, with respect to mutual fund governance generally the Senate Report states that:

> "The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, at 34.

Thus, far from supplying the necessary "clear indication of congressional intent" required by *Santa Fe* in order to supplant state law, if anything the statutory sections relied upon by the Court of Appeals as the basis for its decision reveal a clear intent to the contrary.[30]

Even more remarkable is that another Circuit had previously found the same sections of the Investment Company Act to express Congress' intent to strengthen and enhance the exercise of independent directoral judgment, rather than to withdraw it. In *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973), a decision not even cited by the court below, a mutual fund shareholder suing derivati-

[30] Interpretation of the federal securities laws in a manner opposite from or contrary to the intent of Congress, even by specialized agencies such as the Securities and Exchange Commission, is not unknown. *Cf., SEC* v. *Sloan,* ___ U.S. ___, 46 LW 4426, 4428-29 (May 15, 1978).

vely for his fund's benefit sought damages from the fund's investment adviser under the Investment Company and Clayton Acts for allegedly excessive advisory fees. There, as here, the shareholder claimed that the independent directors whose presence on the mutual fund board was mandated by the Investment Company Act were disqualified from exercising their business judgment as to the disposition of the proposed claims against the investment adviser because the adviser "dominated and controlled" the entire fund board. 479 F.2d, at 262. The shareholder's claim that demand on the directors was excused because different rules of directorial control of corporate affairs should be applied in light of the peculiarities of the mutual fund business and Congress' passage of the Investment Company Act was emphatically rejected by the Court of Appeals for the First Circuit:

> "Nor do we think that an exception [to the business judgment rule] is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. . . . We do not believe . . . that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from disinterested directors in any other corporate venture. . . . To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." 479 F.2d, at 266-67.

Quite obviously the ***Kauffman*** court and the court below cannot both be right. Interpreting the same statute, the First Circuit clearly stated that Congress did not intend to repeal well-established limitations upon the availability of stockholder derivative actions, and that an independent mutual fund director (just as any other corporate director) should properly decide whether pursuit of claims against the fund investment adviser is in the fund's best interests. The Second Circuit has reached the opposite conclusion in the case at bar.

Moreover, the position of the court below conflicts with prior decisions of the Second Circuit. In *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the Second Circuit had determined that independent mutual fund directors should as a matter of Investment Company Act policy not be deprived of the opportunity to exercise their business judgment with respect to fund claims against the investment adviser, and that the independent directors were entitled to full disclosure of potential fund-adviser conflicts for the very purpose of "exercis[ing] the independent judgment that Congress clearly intended." 533 F.2d, at 745. *Fogel* made clear that if, after full disclosure, independent fund directors determined not to pursue fund claims against the investment adviser, such decision would be upheld as "a reasonable business judgment." *Id.*, at 750. The decision

below also conflicts with *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir. 1977), *cert. denied,* 98 S.Ct. 421 (1977), where the Second Circuit held, largely in accordance with the *amicus curiae* argument of the Securities and Exchange Commission, that a mutual fund breach of fiduciary duty claim raised derivatively by a shareholder against the investment adviser was fully subject to independent directorial control under the business judgment rule. *Id.,* at 418-19. With respect to Congressional intent, the Second Circuit held in *Tannenbaum* that:

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the [fiduciary monies sought to be recovered by the shareholder-plaintiff] from the informed discretion of the independent members of a mutual fund's board of directors." *Id.,* at 417.

Thus, at the very least the decision below has resulted in an unsettled state of the law that is both confusing to the mutual fund industry and disruptive to the management of an important segment of our financial economy. If the Court of Appeals' decision is not promptly revised in harmony with the business judgment rule, the inevitable consequence, even if that decision is confined to the mutual fund context, will be to shift major matters of mutual fund management from the board room to the federal courtroom—a result surely not required by the Investment Company Act. A single disgruntled shareholder who can produce a complaint attacking some of the directors which can withstand a motion to dismiss can totally preempt the corporation's independent directors on

the matter at issue, and have the decision which he or she wishes to challenge reviewed by a federal court. The system of mutual fund management contemplated by Congress and previously implemented by the courts will become as anarchistic as the business judgment rule is democratic.

Conclusion

For the foregoing reasons, it is respectfully urged that the petition for a writ of certiorari should be granted.

June 9, 1978

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APPENDIX

APPENDIX A
Rules and Statutes Involved

Delaware General Corporation Law

§ 141. Board of directors; powers; etc.

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of 1 or more members. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors. Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater

number. Unless the certificate of incorporation provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than ⅓ of the total number of directors except that when a board of 1 director is authorized under the provisions of this section, then 1 director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.

* * *

Investment Company Act of 1940

§ 36. Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules,

regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Aug. 22, 1940, c. 686, Title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.

Rule 23.1, Federal Rules of Civil Procedure

Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the

action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Added Feb. 28, 1966, eff. July 1, 1966.

APPENDIX

IN THE

Supreme Court of the United States

October Term, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SECOND CIRCUIT

PETITION FOR CERTIORARI FILED JUNE 2, 1978
CERTIORARI GRANTED OCTOBER 2, 1978

INDEX

Relevant Docket Entries

United States District Court for the Southern District of New York

February 5, 1973—Filed complaint and issued summons.

November 12, 1973—Filed ORDER that the motion of defendants is hereby granted and ordered, that all further actions are stayed until twenty days following the trial or other determination of the claims asserted by Fundamental Investors, Inc. against Goldman, Sachs & Co. in the action entitled: *Welch Foods, Inc., et al.* v. *Goldman, Sachs & Co.*, 70 Civ. 4811 (the Welch action), or until further order of this Court; ordered that this order is granted without prejudice to an application by plaintiffs to vacate the same should it appear that the claims asserted by Fundamental Investors, Inc. against Goldman, Sachs & Co. in the Welch action are not being prosecuted with reasonable diligence.—Gurfein, Jr. (m/n)

February 3, 1975—Filed deft. Fundamental Investors, Inc.'s affdvt. and notice of motion to dismiss under Rule 12(b)—ret. 2-20-75.

September 26, 1975—Filed OPINION #43128 . . . that the motion under Rule 12(b) by THE FUND, joined by all defendants is denied without prejudice to renew the same upon the completion of discovery.—So ordered—Werker, J. m/n

October 14, 1975—Filed pltf's affdvt. and notice of motion for reargument of Court's opinion #43128—ret. 10-27-75.

January 7, 1976—Filed Order that plaintiffs' motion for reargument based on Judge Gagliardi's decision on *Boyko* v. *The Reserve Fund, Inc.*, is denied. Werker, J. m/n.

Docket Entries

July 30, 1976—Filed deft. Fundamental Investors affdt. of Roger Wickers in support of renewed motion to dismiss.

September 20, 1976—Filed deposition of Louis Frederick Laun dtd. 4-6-76.

September 20, 1976—Filed deposition of William J. Stephens dtd. 2-26-76.

September 20, 1976—Filed deposition of Mary S. O'Connor dtd. 3-9-76.

September 20, 1976—Filed deposition of John R. Haire dtd. 2-10-76.

September 20, 1976—Filed deposition of Beryl Robichaud dtd. 3-9-76.

September 20, 1976—Filed deposition of Leon T. Kendall dtd. 2-26-76.

September 20, 1976—Filed continued deposition of Leon T. Kendall dtd. 3-24-76.

September 20, 1976—Filed plaintiffs' deposition exhibits (re depositions of Haire, Kendall, O'Connor, Stephens, Robichaud and Laun).

January 12, 1977—Filed OPINION #45516 . . . Summary judgment is granted to the defendants—Werker, J. m/n.

January 17, 1977—Filed JUDGMENT AND ORDER that defendants have judgment against the plaintiffs dismissing the complaint.—Clerk. m/n.

January 27, 1977—Filed pltfs notice of appeal to the USCA for the 2nd Circuit from final judgment dismissing action and from prior rulings that produced final judgment.—copies mailed.

Relevant Docket Entries

United States District Court of Appeals for the Second Circuit

August 31, 1977—Argument heard (By: Lumbard, Oakes, Meskill, C.J.J.)

January 11, 1978—Judgment reversed, Lumbard, C.JJ.

January 25, 1978—Filed petition for rehearing and rehearing en banc, appellee, pfs.

March 9, 1978—Filed order denying petition for rehearing.

March 9, 1978—Filed order denying petition for rehearing en banc.

June 2, 1978—Call from Supreme Court that petition was filed today.

October 6, 1978—Filed certified copy of order of Supreme Court that writ of certiorari is hereby granted [October 2, 1978].

OPINIONS OF THE DISTRICT COURT

AND

COURT OF APPEALS

First Opinion of the District Court

UNITED STATES DISTRICT COURT,
S. D. NEW YORK.
Sept. 24, 1975.

As Amended October 17, 1975.

———o———

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs,

v.

HARRY G. BURKS, JR., et al.,

Defendants.

No. 73 Civ. 552 (HFW.)

———o———

MEMORANDUM DECISION AND ORDER

WERKER, *District Judge*.

This is a shareholders' derivative action brought by two stockholders on behalf of Fundamental Investors, Inc. ("Fundamental" or the "Fund"), a registered investment company under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* The defendants are the Fund's investment adviser, Anchor Corporation ("Anchor"), a registered investment adviser under the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1 *et seq.*, and several former and present members of the Board of Directors of the Fund. The dispute between the parties centers around the Fund's purchase, on Anchor's recommendation, of $20 million in commercial paper of the now bankrupt Penn Central Transportation Company. As described in detail below the com-

plaint charges that in connection with the purchase of the Penn Central paper the defendants violated various sections of the Investment Company Act, the Investment Advisors Act and the common law. The Fund, joined by all defendants, has now moved under Rule 12(b) of the Federal Rules of Civil Procedure to dismiss this action on the ground that the independent members of the Board of Directors of the Fund have unanimously determined that, in their business judgment, this action is contrary to the best interests of the shareholders of the Fund.

Background

The Fund made its purchases of Penn Central 270-day notes from Goldman, Sachs & Co., in lots of $5 million each on November 26, December 2, 4 and 8, 1969. Unfortunately for the Fund and other holders of Penn Central commercial paper, Penn Central, on June 21, 1970, filed a petition for reorganization under section 77 of the Bankruptcy Act with the result that the notes were not paid at maturity or at any time to date. Faced with the possibility of a substantial loss, the Fund and other plaintiffs instituted suit in the Southern District of New York on November 4, 1970 against Goldman, Sachs & Co., for rescission of their purchases of the Penn Central Notes. That action was entitled *Welch Foods, Inc.* v. *Goldman, Sachs & Co.*, D.C., 398 F.Supp. 1393 (the "*Welch*" action).

The instant derivative suit was filed on February 5, 1973. Jurisdiction was predicated on section 44 of the Investment Company Act of 1940 (15 U.S.C. § 80a-43), section 214 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-14) and pendent jurisdiction. The complaint alleges that in making the purchases of Penn Central commercial paper

the Fund and Anchor relied solely and exclusively on Goldman, Sachs & Co., and made no independent investigation of the financial condition of Penn Central or the quality of its commercial paper. By failing to make an independent investigation it is alleged that Anchor failed to meet its responsibility as the Fund's investment adviser and that the Fund's directors knew or should have known of, and acquiesced in, the failure of Anchor to meet its responsibilities and thus failed to meet their responsibilities as members of the Fund's Board of Directors. Had an independent investigation been made it is alleged that a number of material adverse facts concerning the financial condition of the Penn Central and the quality of its commercial paper would have been learned. As a result of their actions, or inactions, the defendants are charged with engaging in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund in violation of section 36 of the Investment Company Act. Anchor is also alleged to have violated section 206, the antifraud section of the Investment Advisors Act of 1940. Plaintiffs also claim that the defendants violated their common law fiduciary duty to the Fund and that Anchor, aided and abetted by the directors, breached its investment advisory contract with the Fund.

The complaint goes on to allege that from November 28, 1969 to June 21, 1970, the date Penn Central filed for reorganization, the financial condition of the Penn Central deteriorated. During this period it is alleged that Anchor and the Fund directors failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn Central and the quality and safety of its commercial papers. It is also alleged that during this period the Fund's directors failed in their obli-

gations to make adequate attempts to resell the Penn Central commercial paper it held and that Anchor failed to advise the Fund of the advisability of selling the commercial paper. Plaintiffs again claim that these acts by the defendants violate section 36 of the Investment Company Act; that Anchor violated section 206 of the Investment Advisers Act; that all defendants breached their common law fiduciary duty; and that Anchor, aided and abetted, by the Fund's directors breached its investment advisory contract. Finally, the complaint alleges that the defendants violated section 13 (a)(3) of the Investment Company Act by allowing the Fund to hold more than 10% of the securities of any one issuer (Penn Central) in contravention of the Fund's registration statement filed pursuant to section 8(b) of the Investment Company Act.

Subsequent to the filing of this derivative action, all defendants moved to stay this action pending the resolution of the claims of Fundamental in the *Welch* action. The stay was granted by Judge Gurfein on November 12, 1973. Fundamental's claims against Goldman, Sachs & Co., in the *Welch* action were settled on July 9, 1974. The terms of the settlement provided that Goldman, Sachs & Co. would take back the Penn Central notes, pay Fundamental $5,250,000.00 in cash and assign to Fundamental a 73.-75% interest in the proceeds of the notes in the reorganization proceedings.

With the settlement of the *Welch* action, Fundamental had to determine what position to take in this suit. It is necessary to set forth in detail the actions taken by the Fund's Board of Directors since it forms the basis of the defendants' motion to dismiss.

Fundamental's Board of Directors met on July 24, 1974 to review the settlement of the *Welch* action and to decide

what position to take in this derivative action. Since five of the directors are defendants in this action and one is a director of Anchor, the Board determined that the remaining five directors who they considered disinterested would, acting as a quorum pursuant to the bylaws,[1] decide what position the Fund should take in this action. The five disinterested directors then decided to retain the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the entire Penn Central matter and to report to the Board.

After reviewing the complaint in this derivative action, the proceedings in the *Welch* action, the files of Anchor and the Fund relating to the purchase of Penn Central paper and after interviewing officers and employees of the Fund and analyzing the facts and the law, Judge Fuld sent a memorandum to the disinterested directors on December 5, 1974 in which he stated his opinion that there was "no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and re-

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[1] Section 1 of Article Eight of the Certificate of Incorporation of Fundamental provides that:

> "The number of directors which shall constitute the whole board of directors shall be such as from time to time shall be fixed by or in the manner provided in the by-laws which shall also provide the number of directors which shall contsitute a quorum; provided, that in no case shall a quorum be less than one-third of the total number of directors nor less than two directors."

Section 4 of Article Six of the By-Laws of Fundamental provides that:

> "*Quorum:* Except as otherwise provided by law, the Certificate of Incorporation, or these By-Laws, at all meetings of the Board of Directors one-third of the directors then in office, but not less than three directors shall be necessary for the transaction of business."

tention of the Penn Central commercial paper." (Dec. 5, 1974 Memorandum at 2). Judge Fuld went on to discuss in detail each of the claims asserted in this suit. Finally, Judge Fuld defined and discussed three alternative courses of action which the disinterested directors might pursue, *i. e.*, (1) seek realignment so as to become a plaintiff for the purpose of exercising control over and prosecuting the action; (2) conclude that the action is sufficiently lacking in merit and move to have the suit dismissed; and (3) take a neutral position and permit the action to proceed for the Fund's benefit under the auspices of the present plaintiffs.

After the disinterested directors reviewed his report and submitted questions to him, Judge Fuld sent a supplemental memorandum to the disinterested directors on December 18, 1974. In his memorandum Judge Fuld discussed in more detail the possibility that the Board should move to dismiss this suit as not being in the best interests of the Fund and the possible scope of judicial review of such a decision.

The disinterested directors then met in a series of special meetings to consider Judge Fuld's memoranda. The directors met with Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, unaffiliated directors of Fundamental; and Eugene Souther, litigation counsel to Fundamental in this action. Questions were posed by the directors to all of these in attendance concerning the merits of the derivative action and the alternatives open to the Fund's Board. The disinterested directors again met in private and decided to give additional consideration to the problem and convey any questions to the designated Chairman of the disinterested directors, Leon T. Kendall.

A second special meeting of the disinterested directors was held on January 6, 1975. Upon review of the alter-

natives available, the directors present unanimously determined [2] that the prosecution of this action was contrary to the best interests of the shareholders of Fundamental and that counsel should be directed to seek dismissal of the action. The factors considered by the directors in reaching their conclusion are summarized in the Kendall affidavit ¶ 22, and are as follows:

> "(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;
>
> (b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;
>
> (c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to re-remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

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[2] One director, Mary S. O'Connor, was not present at the meeting. She had previously told Mr. Kendall what her decision was. That vote was reaffirmed by Mrs. O'Connor at a special meeting of the disinterested directors held on January 22, 1975. Even without her presence, four directors would constitute a quorum.

(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central comercial paper;

(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash;

(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analysed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be liable to Fundamental; and

(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

Discussion

The Fund now argues that the extensive consideration given to the alternatives available to the independent directors culminating in their decision to seek dismissal of this suit was a good faith exercise of business judgment which cannot be upset by the two shareholder plaintiffs who would force Fundamental to maintain this action. The plaintiffs, of course, dispute this position. After emphasizing, the merits of the claims they have asserted and criticizing the conclusions reached by Judge Fuld, plaintiffs make the following arguments in opposition to the defendants' motion to dismiss: (1) because of the broad regulatory legislation embodied in the Investment Company and Investment Advisers Act, the decision whether to prosecute violations of that Act is not a matter of "business judgment" to

be decided by directors of a regulated fund; (2) to seek dismissal of the action would be tantamount to an unlawful ratification of defendants' conduct; (3) if a majority of the board's directors are disqualified, the existence of a "disinterested" minority is irrelevant; (4) as a matter of law the minority directors are not "disinterested;" (5) the minority directors gave undue deference to Anchor in making their decisions; and (6) the motion is premature and defective under Rule 23.1. These arguments will now be considered.

At the outset, the obvious should be stated—a shareholder's derivative suit is an action brought on behalf of a corporation in which any recovery runs in favor of the corporation. Ordinarily, it is the corporation which would seek the right to enforce any cause of action it might have. Rule 23.1 of the Federal Rules of Civil Procedure requires that a complaining shareholder demand action from the board of directors before bringing suit.[3] The purpose of

[3] Rule 23.1 provides:

"In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

that "demand" rule "is to give the derivative corporation itself the opportunity to take over a suit which was brought on its behalf in the first place, and thus to allow the directors the chance to occupy their normal status as conductors of the corporation's affairs." *Brody v. Chemical Bank,* 517 F.2d 932 at 934 (2 Cir. 1957), citing *In re Kauffman Mutual Fund Actions,* 479 F.2d 257, 263 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973).

No demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are defendants charged with wrong doing and as such a demand would be futile.[4] While no set formula has been developed for determining what facts must be plead in order to excuse a demand on the Board of Directors—*see generally,* 7A Wright & Miller Federal Practice & Procedure § 1831 (1972)—that issue is not presented in this case. Instead, this case presents the rather unique situation where a designated independent minority of a Board has taken unilateral action with respect to a suit brought on behalf of the corporation. The decision of the independent directors was made after the settlement of the *Welch* action which put an end to the stay in this suit. Plaintiffs argue that even if suit were instituted at the present time (*i.e.,* after settlement of the *Welch* action no prior demand on the Fund's Board would have been necessary because the majority of directors would be disqualified. To allow a minority of the Board to seek dismissal of the suit would, it is argued, destroy the role of "presumptive disqualification."

[4] No issue has been raised concerning whether a demand on the shareholders was necessary. Plaintiffs' complaint alleges that under applicable law and the Certificate of Incorporation and By-Laws of the Fund, the directors and officers are vested with the management of the Fund. Complaint ¶7(b).

While no case is directly in point, this circuit has recently considered an analogous issue in *Brody* v. *Chemical Bank, supra.* There, the district court had dismissed the derivative causes of action in plaintiff's complaint because the allegations in the complaint were insufficient to excuse a demand on the Board of Directors. Plaintiff had alleged futility of demand because the majority of directors were controlled by the defendant corporation. However, since institution of the suit, a new Board had been installed but no demand was made on it. The Second Circuit agreed that a demand should have been made but remanded because of the gravity of the alleged wrongdoing. 482 F.2d 1111 at 1114 (2 Cir.) After remand, the plaintiffs filed a second amended complaint but made no demand on the Board of Directors because they alleged that a demand on the Board of Directors at the time the action was originally commenced would have been futile. The district court again dismissed the derivative counts and the Second Circuit affirmed on the reasoning that a demand should have been made on the new directors. *Brody, supra* at 934.

In this case, within a short period after settlement of the *Welch* action and the dissolution of the stay, the Board of Directors met and designated the independent directors to make a decision as to the Fund's position in this suit. In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. *See* 3B J. Moore, Federal Practice ¶ 23.1.19, at 23.1-252-53 (2d ed. 1974) quoted in *Brody, supra* at 934.

Although the independent directors could properly move for dismissal of this action it is now necessary to determine whether good faith business judgment of the directors can be used as a ground for dismissal. Defendants rely on a line of cases which hold that absent fraud or corruption or other disqualifying factor, the good faith business judgment of the directors not to bring suit is final. *See, e.g., Hawes v. Oakland,* 104 U.S. 450, 26 L.Ed. 827 (1881); *Corbus v. Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 23 S.Ct. 157, 47 L.Ed. 256 (1903); *United Copper Securities Co. v. Amalgamated Copper Co.,* 244 U.S. 261, 37 S.Ct. 509, 61 L.Ed. 1119 (1917); *Swanson v. Traer,* 249 F.2d 854 (7th Cir. 1957); *Ash v. IBM,* 353 F.2d 491 (3d Cir. 1965), *cert. denied,* 384 U.S. 927, 86 S.Ct. 1446, 16 L.Ed.2d 531 (1966); *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857, 94 S.Ct. 161, 38 L.Ed.2d 107 (1973). *Cf. Allegheny Corp. v. Kirby,* 344 F.2d 571 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28, 86 S.Ct. 1250, 16 L.Ed.2d 335 (1966).

As the Supreme Court recognized in *United Copper, supra,* the decision whether or not to sue is a matter of internal management. 244 U.S. at 263, 37 S.Ct. 509. Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue.

> "[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers . . . This rule applies whether the mistake is due to error of fact or of law, or merely to bad business judgment. It applies . . . where the mistake alleged is the refusal to assert a seemingly clear cause of action . . . ."

Ashwander v. Valley Authority, 297 U.S. 288, 343, 56 S.Ct. 466, 481, 80 L.Ed. 688 (1936).

The reasoning behind the "business judgment rule" and its application to derivative suits was recently discussed in this district in *Bernstein v. Mediobanca, Docket* #73 Civ. 3549, (S.D.N.Y. Dec. 24, 1974) (Connor, J.). There the Court reaffirmed the business judgment rule although summary judgment was denied, with leave to renew, because possible evidence of bad faith on the part of the Board of Directors in deciding not to sue was in the possession of the defendants and plaintiff was given an opportunity to discover it.

This court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provision with respect to suits brought under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. *Brown v. Bullock,* 194 F.Supp. 207 (S.D.N.Y., *aff'd* 204 F.2d 415 (2d Cir. 1961); *Bolger v. Laventhol, Krekstein, Horwath & Horwath,* 381 F.Supp. 260 (S.D.N.Y. 1974). It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is "implied" the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether

to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final.

The court must also reject plaintiffs' argument that the decision not to sue was tantamount to an illegal ratification. Although it can be argued that derivative suits should be allowed when the Board has refused to sue on a non-ratifiable wrong—*see* Note, Demand on Directors and Shareholders as a Prerequisite To a Derivative Suit, 73 Harv.L.Rev. 746, 762 (1960); *Rogers v. American Can Co.,* 305 F.2d 297 (3d Cir. 1962), the question of business judgment is separate from the question of ratification. *S. Solomont & Sons Trust v. New England Theatres Operating Corp.,* 326 Mass. 99, 93 N.E.2d 241, 247 (1950). Many of the cases which established the business judgment rule and its relation to derivative suits have involved claims which were arguably non-ratifiable. *See, e. g., United Copper, supra; Ash v. IBM, supra* (antitrust violations).

Another question which has been considered is whether the merits of the plaintiffs' claim should be considered in deciding whether the directors decision should be upheld. To do so would place the Court in the position of substituting its judgment for that of the directors which if made in good faith should not be disturbed. The court has carefully reviewed the many factors which the Board considered before making its decision not to sue. Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, there were many other factors considered by the directors, as outlined in the Kendall Affidavit ¶ 22—which led the directors to their decision.

If the minority directors were truly disinterested and independent the court will not substitute its judgment for

that of the Board. Plaintiffs have not argued that the minority directors have acted fraudulently or corruptly. They have argued that they are not disinterested or independent because they occupy similar positions with other funds in the Anchor group and that Anchor controls the selection and nomination of the Fund's directors. This assertion has been denied and it is alleged by the movant that these directors were nominated by a three man Directors Qualification Committee of which two members were unaffiliated with Anchor.

Interest or lack of independence would go toward the issue of good faith. I am constrained therefore to permit the plaintiffs to pursue discovery with respect to the relationships of the minority directors and the Qualifications Committee to determine whether the minority directors were disinterested or independent. It would appear that all of the other questions resolved herein are dependent upon a resolution of this issue. The plaintiffs are to conduct their discovery within 90 days from the date hereof.

The motion is denied without prejudice to renew the same upon the completion of discovery.

So ordered.

Unreported Opinion and Order of the District Court Denying Reargument

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

HOWARD M. LASKER AND IRVING GOLDBERG,

Plaintiffs,

against

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHINSON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA WADE, ANCHOR CORP., and FUNDAMENTAL INVESTORS, INC.,

Defendants.

ORDER

HENRY F. WERKER, *D. J.*

Plaintiffs' motion for reargument based on Judge Gagliardi's decision in *Boyko* v. *The Reserve Fund, Inc.*, 74 Civ. 3419 (S.D.N.Y. Sept. 31, 1975) is denied. This court finds that *Boyko* is distinguishable from the case at hand due to the fact that *Boyko* concerns Section 36(b) of the Investment Company Act, 15 U.S.C. § 80a-35(b). That section specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under Section 36(a), 15 U.S.C. § 80a-35(a), where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim.

So ordered.

Dated: New York, New York
January 6, 1976

HENRY F. WERKER
U.S.D.J.

Second Opinion of the District Court

UNITED STATES DISTRICT COURT,
S. D. NEW YORK.
Jan. 7, 1977.

HOWARD M. LASKER and IRVING GOLDBERG,
Plaintiffs,

v.

HARRY G. BURKS, JR., *et al.*,
Defendants.

No. 73 Civ. 552 (HFW).

OPINION

WERKER, District Judge.

This action, brought derivatively by two shareholders on behalf of Fundamental Investors, Inc. ("Fundamental" or the "Fund"), a registered investment company, seeks to recover damages resulting from the Fund's purchase of $20 million in 270-day notes issued by the now bankrupt Penn Central Transportation Company. The defendants are Anchor Corporation ("Anchor"), the registered investment adviser to the Fund, and several past and present members of the Fund's Board of Directors ("Board"). The defendants previously moved to dismiss this suit under Rule 12(b) of the Federal Rules of Civil Procedure because a voting quorum of disinterested directors found, in the ex-

ercise of its business judgment, that maintenance of the suit would not be in the best interests of the shareholders of the Fund. In a memorandum decision on that motion, 404 F. Supp. 1172, this court held that the business judgment rule [1] applied to the actions of the Fund and that it enabled the minority directors of the Board to seek dismissal of this suit provided only that they were "truly disinterested and independent." However, the court permitted the plaintiffs to conduct discovery for a designated period of time to determine whether the minority directors were in fact disinterested or independent, and the motion to dismiss was denied without prejudice to renew at the close of discovery. In accordance with that decision, the defendants have now renewed their motion to dismiss the instant action. The plaintiffs continue to argue that the motion should be deniel because, for various reasons, the minority directors did not, and could not, exercise their independent business judgment in moving to terminate this action.

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[1] Under the rule,

"'. . . Questions of policy of management, expediency of contracts or action, adequacy of consideration, lawful appropriation of corporate funds to advance corporate interests, are left solely to their honest and unselfish decision, for their powers therein are without limitation and free from restraint, and the exercise of them for the common and general interests of the corporation may not be questioned, although the results show that what they did was unwise or inexpedient.' *Politz* v. *Wabash R. Co.*, 207 N.Y. 113, 124, 100 N.E. 721, 724. Indeed, although the concept of 'responsibility' is firmly fixed in the law, it is only in a most unusual and extraordinary case that directors are held liable for negligence in the absence of fraud, or improper motive, or personal interest." *Bayer* v. *Beran*, 49 N.Y.S.2d 2, 6 (Sup. Ct. 1944).

I

The facts surrounding this action have been described at length in my earlier memorandum decision; nevertheless, some repetition of that discussion will facilitate an understanding of the court's action upon the present motion by the defendants.

The complaint alleges, among other things, that Anchor breached its statutory, contractual and common law fiduciary duties by relying exclusively upon the representations of *Goldman, Sachs & Co.* (a seller of commercial paper), rather than independently investigating the quality and safety of the Penn Central 270-day notes purchased by the Fund. It is further alleged that the defendant directors knew or should have known of Anchor's failure to meet its responsibility; that they violated their common law duties as corporate fiduciaries by acquiescing in Anchor's omissions; that the financial condition of the Penn Central steadily worsened during the period from November 28, 1969 to June 21, 1970, the date that it filed for reorganization; and that during this period of decline all of the defendants failed to investigate and review the financial condition of the Penn Central and the quality and safety of its commercial paper. It is also alleged that during this period Anchor failed to recommend, and the defendant directors failed to attempt, sale of the Penn Central paper held by the Fund.

Prior to the institution of this action, the Fund and other plaintiffs brought suit against *Goldman, Sachs* seeking rescission of their purchases. *See Welch Foods, Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (S.D.N.Y. 1974) (the "*Welch*" action). On the motion of all defendants to this action, Judge Gurfein, then a district court judge, granted a stay of further proceedings in this action pending resolution of the Fund's claims in *Welch*. Thereafter, on July 9, 1974 the Fund agreed to settle its claims against *Goldman, Sachs*. Under the terms of the settlement agreement, *Goldman, Sachs* was to take back the notes and the Fund was to receive $5,250,000 in cash and a 73.75 percent interest in any proceeds of the notes obtained during the course of the Penn Central reorganization proceeding.

With the claims of Fundamental in the *Welch* matter resolved, the Board once again faced the question of what to do in the instant action. Briefly, the Board determined that five of its members were dininterested (the "disinterested quorum" or "minority directors") and therefore able to determine the proper course of action for the Fund.[2] The disinterested quorum then retained the Honorable Stanley H. Fuld, former Chief Judge of the New York Court of Appeals, to review the circumstances surrounding the purchase and retention of the Penn Central notes and prepare an opinion for its consideration. In a memorandum to the disinterested quorum dated December 5, 1974, Judge Fuld concluded that neither Anchor nor the defendant directors of the Fund had violated the law "in connection with the acquisition or retention of the Penn Central commercial paper." Judge Fuld's memorandum discussed several positions that the disinterested quorum could take on behalf of the Fund, one of which was concluding that the suit lacked merit and moving to dismiss. The minority directors met with Judge Fuld at a special meeting of the disinterested quorum held on December 18, 1974 and requested that he submit a further memorandum before they took any action.

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[2] Under Article Eight of the Certificate of Incorporation of Fundamental, a quorum of the Board may not be less than one-third of the total number of directors. Since the full Board consisted of ten members, there was no problem here.

The minority directors also questioned several of the defendants before deciding at a second special meeting of the disinterested quorum, held on January 6, 1975, to seek dismissal of the instant action.[3] An affidavit submitted by the chairman of the disinterested quorum as part of the earlier motion to dismiss recounts ten factors that the disinterested quorum considered in arriving at its decision. The relevant portion of that affidavit appears in my earlier decision, 404 F.Supp. at 1176-77.

II

On the defendants' initial motion to dismiss, this court considered and rejected the contention of the plaintiffs that the merits of their derivative claim should color the court's consideration of the business judgment "defense." The court also reviewed the claim of the plaintiffs that the strong public policy behind the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, and the Investment Advisers Act of 1940, 15 U.S.C. § 80b-1, *et seq.*, precluded application of the business judgment rule to the actions of mutual funds. The court observed that

> "absent a statutory exception whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation, including whether to prosecute a cause of action. 404 F.Supp. at 1180.

Both of these contentions have been reasserted in substantially unchanged form in the plaintiffs' papers in opposition to the renewed motion to dismiss. While a certain degree of tenacity is the mark of accomplished counsel, what the plaintiffs now seek is an opportunity to reargue the court's prior decision after the time to do so has passed. To accede to that request would require the court to reconsider arguments previously rejected without having been shown that there is a need to do so. Consequently, the court will only consider the question it did not reach before: whether the minority directors were disinterested and independent.

[3] As was noted in my earlier decision in this matter, although one of the five minority directors voted by proxy, even without her vote, the presence of four directors at the meeting constituted a quorum.

Since the parties have each submitted affidavits and excerpts from the extensive deposition testimony to assist in the disposition of the instant motion, the court must treat the motion as one for summary judgment under Rule 56 of the Federal Rules of Civil Procedure. Rule 12(b), Fed. R.Civ.P.

III

The plaintiffs first contend that the structure of the mutual fund industry, which subjects mutual funds to extensive control by their investment advisers, precludes a finding of independence in this instance.[4] Specifically, they

[4] In this regard, plaintiffs note Chief Judge Kaufman's recent statement that:

> "The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business. Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser." *Galfand* v. *Chestnutt Corp.*, Civ. No. 76-7156 (S.D.N.Y. Nov. 4, 1976).

maintain that the large number of shareholders in the Fund coupled with the small size of each shareholder's interest, makes proxy contests impossible to wage and ensures that the Board will only contain directors amenable to the policies of the Fund's management.[5] The plaintiffs also suggest that the service of each minority director for compensation on the boards of other "Anchor" funds demonstrates their inability to act independently. In this vein, the plaintiffs maintain that business and personal relationships among the defendants and minority directors make it impossible to conclude that the disinterested quorum acted independently; that even if the minority directors acted in good faith, their loyalties must have been divided.

Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently. Although each of the minority directors knew someone on the Board at the time that he or she was nominated, the relationships which existed between the minority directors and the defendant directors were *de minimis,* even as they are stated by the plaintiffs, and do not suggest that the business judgment rule should not be applied.

There is also no reason to conclude that the business judgment rule is inapplicable merely because each minority director receives remuneration for service on the boards of other "Anchor" funds. Most corporate directors receive some compensation for their services, but absent a showing of improper motive they have always been per-

[5] At about the time that the minority directors determined to seek the dismissal of this action, there were approximately 141,000 shareholders in the Fund. No shareholder had a beneficial interest greater than one percent.

mitted to apply their business judgment to decisions involving derivative suits brought against the corporations they serve. *See e.g., Warshaw* v. *Calhoun,* 43 Del.Ch. 148, 221 A.2d 487 (Sup.Ct.1966). I am not persuaded that there is any meaningful distinction between remuneration by one corporation rather than several corporations similar in structure. This is not, after all, an instance where it is alleged that a minority director received payments from the investment adviser or other persons whose interests conflict with those of the Fund.

The plaintiffs' contention that a minority director of a mutual fund can never act independently given the relationship between mutual funds and their advisers parallels, to some extent, their previously rejected argument that the business judgment rule should not apply to mutual funds registered under the Investment Company Act of 1940. In making this claim, plaintiffs apparently rely upon *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824, 97 S.Ct. 77, 50 L.Ed.2d 86 (1976), but that decision is inapposite. In the *Fogel* case, two mutual fund stockholders brought a derivative suit on behalf of a mutual fund against several affiliated fund directors and the advisor to the fund. The plaintiffs sought to recapture a portion of the brokerage commissions paid on fund transactions on the theory that the affiliated directors had "intentionally misled and misinformed the [f]und's unaffiliated directors by telling them that such recapture was not available to the [f]und." *Id.* at 737.

Writing for the *Fogel* panel, Judge Friendly observed that:

> "Congress had mandated independent directors in order 'to supply an independent check on manage-

> ment and to provide a means for the representation of shareholder interests in investment company affairs.' [citation omitted]. The minimum requirement to enable the [f]und's independent directors to discharge these duties with respect to recapture was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors."

Id. at 749-50.

Significantly, Judge Friendly went on to observe that:

> "If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the [f]und should make no effort at recapture, we would have a different case."

Id. at 750.

In the instant action, the minority directors were furnished with disinterested counsel who analyzed the lgal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them. Clearly, then, under *Fogel* it was proper for them to determine what the Fund's posture would be.

IV

The plaintiffs next contend that the lack of true independence and disinterestedness on the part of the minority directors is apparent from the manner in which they decided to seek dismissal in the instant action. In support of this claim, plaintiffs point to the actions of Roger T. Wickers, an Anchor vice-president who formerly served as the secretary to the Fund, and Eugene P. Souther, who was retained as special counsel to the Fund for the purposes of this litigation, as well as to the circumstances surrounding the meetings of the minority directors.

At the direction of defendant Haire, Wickers explored the possibility of retaining special counsel for the disinterested quorum. After contacting several distinguished attorneys, Wickers reported that Judge Fuld would be available to serve the minority directors and, at a Board meeting held on July 24, 1974, it was Wickers who proposed that a disinterested quorum act for the Fund in the instant action. Wickers also coordinated the arrangements for Judge Fuld's investigation for the minority directors, who were residents of several different states.

The plaintiffs maintain that "the inappropriateness of Wickers role as intermediary is manifest," but I disagree. The plaintiffs have not set forth any facts in support of their suggestion that Wickers improperly influenced the deliberations of the disinterested quorum. Instead they have engaged in totally unsubstantiated supposition. For example, plaintiffs contend that Wickers retained Judge Fuld, but the sworn affidavit of Wickers and the deposition of at least one minority director establish that Judge Fuld was retained by the minority directors to act upon instructions communicated to him at the direction of the disin-

terested quorum.[6] In the absence of some factual support for the plaintiffs' allegations, the court cannot conclude that it was improper for Wickers to coordinate the administrative details of Judge Fuld's inquiry or that Wickers' actions reduced the independence of the minority directors.

It is the court's opinion that the role of Souther was equally innocent. The plaintiffs advance two reasons why it was inappropriate for him to participate as he did in the deliberations of the disinterested quorum. First, they note that he was an "interested person" within the meaning of § 2 of the Investment Company Act, 15 U.S.C. § 80a-2(a)(19)(A)(iv)[7] because his law firm had acted as legal counsel to the Fund during the last two fiscal years. They question whether the minority directors could arrive at a disinterested decision when they were advised by an attorney who was "interested." Second, the plaintiffs contend that it was improper for his firm to counsel parties with divergent interests, namely the Fund and the disinterested quorum.

All attorneys providing legal counsel to mutual funds become, by definition, "interested persons" for some period

[6] Even if Wickers did retain Judge Fuld for the minority directors, I see nothing improper in that. In fact, in *Fogel, supra,* Judge Friendly suggested that it was desirable for disinterested counsel to be *"furnished"* to the independent directors.

[7] Under the statute:

"(19) 'Interested person' of another person means—
(A) when used with respect to an investment company—

* * * * *

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company . . ."

of time. Under § 10 of the Investment Company Act, 15 U.S.C. §80a-10, only 60 percent of the members of the board of a registered company may be interested persons. Designating Souther as an interested person, therefore, only serves to limit his participation on the Board as a *director*. It does not mean that the minority directors were interested in the suit, that their deliberations were somehow subject to improper influence or that they lacked the necessary degree of independence.

Plaintiffs nevertheless suggest that in accordance with Judge Frankel's recent decision in *Papilsky v. Berndt*, CCH Fed.Sec.L. Rep. ¶ 95,027 (S.D.N.Y. 1976), it was improper for Souther to advise both the Fund and the minority directors. However, in *Papilsky* the law firm advising the fund also served as the investment adviser's counsel, and, as Judge Frankel noted, there was no "suggestion to the Board that, because of the possible conflict of interest, the independent directors should seek disinterested counsel." *Id.* at 90, 133. In the instant action, independent legal advice for the minority directors was not only recommended, it was also obtained. Moreover, there was no conflict of interest on the part of Souther or his law firm: they were retained to represent the Fund in the instant action and it was the disinterested quorum, acting for the Fund, which gave them their instructions as to how to proceed.

The plaintiffs also contend that the presence of several defendants during the initial presentations of Judge Fuld and Souther at the first special meeting of the disinterested quorum demonstrates the minority directors' lack of independence. But the minutes of that meeting and the deposition testimony show that the minority directors invited those defendants to join the meeting so that they could

answer questions raised by the minority directors. The minutes of the meeting also indicate that all of the defendants and counsel were excused before the disinterested quorum determined in executive session that it wished to review the pertinent documents and formulate further questions to be answered before reaching any decision.

In this context plaintiffs point to the allegedly misleading nature of statements made to the minority directors by defendant Haire. The minutes of the first special meeting of the disinterested quorum state that Haire "questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if [the instant action] were being pursued with the acquiescence, if not under the control, of the Fund." The plaintiffs consider this to be in sharp disagreement with Haire's testimony at his disposition that he "never at any time had any doubt that [Anchor] could continue to effectively serve the [F]und if . . . requested to continue or permitted to continue by the board or the shareholders." Apparently to underscore the materiality of Haire's discouraging words to the minority directors, plaintiffs note the contents of an affidavit by the chairman of the disinterested quorum. In that affidavit, the quorum chairman states that in reaching their decision the directors considered that:

> "(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment advisor and to seek to retain a new investment advisor; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders . . ."

The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows only that the minority directors reached a different conclusion: that prosecution of the suit "would necessarily cause the Fund to seek to obtain a different investment adviser immediately." Even if the minority directors erred in this determination, as I have noted in my previous decision, the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence.

V

Finally, the plaintiffs contend that under *Perlman v. Feldman*, 219 F.2d 173, 178 (2d Cir.), *cert. denied*, 349 U.S. 952, 75 S.Ct. 880, 99 L.Ed. 1277 (1955), and *Pepper v. Litton*, 308 U.S. 295, 306, 60 S.Ct. 238, 84 L.Ed. 281 (1939), the defendant directors bear the burden of proving by clear and convincing evidence that they did not breach their fiduciary responsibilities to the corporation and its stockholders. The defendants argue that the plaintiff must shoulder the evidentiary burden because it is the exercise of business judgment by corporate directors which is chal-

lenged. *Bellis v. Thal,* 373 F.Supp. 120, 124 (E.D.Pa.1974), *aff'd,* 510 F.2d 969 (3d Cir. 1975); *Marco v. Bank of New York,* 272 F.Supp. 636, 639 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 628 (2d Cir. 1968); *Warshaw v. Calhoun, supra.*

The *Perlman* and *Pepper* cases relied upon by the plaintiffs both involve self-dealing by corporate fiduciaries and are inapplicable here. As I noted in my earlier decision in this matter, the plaintiffs "have not argued that the minority directors have acted fraudulently or corruptly." 404 F.Supp. at 1180. Moreover, the question before the court is not whether *the defendants* breached their fiduciary obligations to the corporation, but whether suit can proceed against them at all given the decision of the nondefendant minority directors to seek dismissal of this action.

It is therefore incumbent upon the plaintiffs to establish that the minority directors actions lacked independence. *Marco v. Bank of New York, supra.* The unsupported contentions of the plaintiffs clearly fail to meet this burden and, accordingly, it is the opinion of this court that the defendants, both corporate and individual, cannot be required to proceed to a trial. I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so. The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that

they communicated extensively among themselves before reaching a decision to seek dismissal of this suit.

To conclude that the disinterested quorum acted in response to pressure and without justification to immunize Anchor and the defendant directors from possible liability would require this court to presume that bias exists based upon circumstances which seem entirely innocent. For example, as has been noted, the plaintiffs suggest that a finding of improper influence must follow from the fact that the minority directors each knew someone on the Board when they were first selected for nomination or election to the Board. But the existence of casual relationships among the directors, without more, cannot be taken as an indication that the minority directors were unable to reach an independent business decision. Similarly, because the Investment Company Act terms an attorney whose advice is sought to be an "interested person," plaintiffs seek to suggest that the minority directors had an interest in the contested transaction which went beyond a generalized concern for the security of the Fund.[8] But here again it was obviously reasonable for the minority directors to consult with interested persons, rather than reaching a decision without speaking to either the directors involved in the transaction or counsel.

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[8] In a similar effort to brand a minority director as interested, plaintiffs point to the following testimony by director Stephens:

> "I remember commenting [at the July 24, 1974 board meeting] on what constituted a disinterested director because in my opinion no director could be disinterested, but I was told that was the proper term.

Later Stephens explained that he didn't like the term "disinterested" since he certainly was not "uninterested."

Second Opinion of the District Court

The court of appeals for this circuit has recently cautioned that summary judgment may not be granted unless, drawing all *reasonable* inferences in favor of the nonmovant, no material factual issue is shown. *Heyman* v. *Commerce and Industry Insurance Co.*, 524 F.2d 1317 (2d Cir. 1975). However, the party opposing the motion must adduce something beyond conclusory allegations. *Donnelly v. Guion*, 467 F.2d 290 (2d Cir. 1972). Here, there has been no showing by the plaintiffs of facts which, if proven, would prohibit the defendants from hiding behind the business judgment cloak. Accordingly, the defendants are granted summary judgment.

SO ORDERED.

Opinion of the Court of Appeals

No. 23, Docket 77-7060.

UNITED STATES COURT OF APPEALS,
Second Circuit.

Argued Aug. 31, 1977.
Decided Jan. 11, 1978.

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Howard M. Lasker and Irving Goldberg,

Plaintiffs-Appellants,

v.

Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey C. Hopkins, S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips, Jeptha H. Wade, Anchor Corporation and Fundamental Investors, Inc.,

Defendants-Appellees.

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Lumbard, Circuit Judge:

This appeal by two mutual fund shareholders raises an important question of first impression: can minority directors of a registered mutual fund, who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act, 15 U.S.C. § 80a-10(a), terminate a nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser? We are of the view that to permit such action by those "independent"

minority directors of a registered mutual fund would be contrary to the public interests which Congress has sought to protect. Accordingly, we reverse the judgment of the district court which dismissed the complaint and remand for further proceedings.

Howard Lasker and Irving Goldberg commenced this derivative action in February, 1973, against individuals who had been directors of Fundamental Investors, Inc. (the Fund), an open-end investment company [1] registered under the Investment Company Act, 15 U.S.C. § 80a-1 to -52, and the Fund's registered investment adviser, Anchor Corporation. The plaintiffs sought to recover losses sustained by the Fund in connection with its purchase between November 28 and December 8, 1969, of $20 million in Penn Central 270-day notes from Goldman, Sachs & Co. The derivative complaint charged the defendants with violations of §§ 13(a)(3) and 36 of the Investment Company Act, 15 U.S.C. §§ 80a-13(a)(3), 80a-35 (1970), breach of their common-law fiduciary duties, violations of § 206 of the Investment Advisers Act, 15 U.S.C. § 80b-6 (1970), and breach of Anchor's investment advisory contract with the Fund.

It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment. On June 21, 1970, Penn Central filed a petition for reorganization which is still in process in the Eastern District of Pennsylvania. Consequently, the Fund's Penn Central notes were not paid at maturity.

[1] An open-end investment company is defined in § 5(a)(1) of the Investment Company Act, 15 U.S.C. § 80a-5(a)(1) (1970), as an investment company that offers "for sale or has outstanding any redeemable securities of which it is the issuer." "Investment company" is defined in § 3(a) of the Act, 15 U.S.C. § 80a-3(a) (1970).

In November 1970, the Fund, joined by three other noteholders,[2] sued Goldman, Sachs in the Southern District of New York for recovery of their losses arising from their purchases of Penn Central notes. In July 1973, then District Judge Gurfein stayed the instant action, which had been commenced five months earlier, pending resolution of the suit against Goldman, Sachs. That suit was settled on behalf of the Fund in July 1974. Under the settlement, Goldman, Sachs took back the Fund's Penn Central notes, paid the Fund $5,250,000, and assigned to the Fund a 73.75 percent interest in the proceeds of the notes in the reorganization proceedings. The Fund's co-plaintiffs did not settle, and the jury rendered verdicts in their favor against Goldman, Sachs for the full amount of their claims.[3]

On July 24, 1974, the Fund's board of directors met and discussed the pending *Lasker* case. They decided that five of the statutorily disinterested directors, none of whom were involved in the derivative action,[4] should decide what action should be taken regarding the *Lasker* case, and act

[2] In addition to the Fund, Welch Foods, Inc., C. R. Anthony Company, and Younker Brothers, Inc. sued Goldman, Sachs in a single action. See *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F.Suppp. 1393 (S.D.N.Y. 1974).

[3] See *Welch Foods Inc. v. Goldman, Sachs & Co.*, 398 F.Supp. 1393 (jury verdict S.D.N.Y. 1974).

[4] Of the remaining six directors of the eleven member board, all were defendants to the *Lasker* action and/or affiliated with Anchor.

accordingly on behalf of the entire board.[5] This procedure had been discussed prior to the July board meeting by the defendant John R. Haire, president of the Fund and chairman of Anchor's board of directors, and Roger Wickers, an officer of both the Fund and Anchor. Upon Haire's instruction, Wickers had ascertained that Stanley H. Fuld, former chief judge of the New York Court of Appeals, would be available to serve as special counsel. The minority directors agreed to consider what should be done about the *Lasker* case, and instructed Wickers to retain Judge Fuld to advise them.

Judge Fuld, in his report of December 5, 1974, supplemented on December 18, 1974, concluded, on the basis of the information furnished to him, that neither Anchor nor the Fund directors would be found liable under federal or state law. At the same time, Judge Fuld pointed out the absence of legal authority on whether a mutual fund's investment adviser is required to conduct independent research regarding its investment recommendations. He further cautioned that it was "impossible to predict . . . what a trier of fact will find, particularly in complex circumstances." After considering the special counsel's reports, on January 6, 1975, the minority directors instructed counsel for the Fund to seek dismissal of the *Lasker* action on the ground that it was their business judgment that further prosecution of the action would not be in the best interests of the Fund.

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[5] Under the Fund's bylaws and Delaware corporate law, five of the Fund's twelve member board of directors constituted a quorum of the entire board. Del.Code tit. 8, § 141 (1975); Fundamental Investors, Inc., Certificate of Incorporation, Article EIGHTH; Fundamental Investors, Inc., Bylaws section 4, Article VI.

The five directors appointed to review the *Lasker* action were: Leon Kendall, elected to the board in June 1974; Beryl Robichaud, elected in September 1973; William Stephens, elected in September 1973; Mary O'Connor, elected in June 1972; and Louis Laun, who became a director in the fall of 1971.

Judge Werker, in passing on the motion to dismiss, held that the minority directors, in the exercise of their business judgment, had the power to bar further prosecution of the case, provided they were truly disinterested and independent. As a factual issue had been raised regarding whether the minority directors were independent and disinterested, he granted discovery on that issue. *Lasker* v. *Burks*, 404 F.Supp. 1172 (S.D.N.Y.1975). After such discovery, the motion to dismiss was renewed and granted by Judge Werker on January 7, 1977. In his second opinion, 426 F.Supp. 844 (S.D.N.Y.1977), Judge Werker found no factual support for the conclusion that the minority directors had not acted independently. In accordance with his earlier opinion, he dismissed the complaint.

From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses. We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.

In response to disclosure of grave abuses in the management of investment companies, Congress in 1940 enacted the Investment Company Act (ICA), 15 U.S.C. §§ 80a-1 to -52 (1970), and the Investment Advisers Act (IAA), 15 U.S.C. §§ 80b-1 to -21 (1970). Congress acted after receiving a report from the Securities and Exchange Commission which showed that investment funds were organized by investment advisers; that the funds were administered under contracts that where highly favorable to the advisers; that the directors of the funds were selected by the investment adviser; and that the board was usually dominated by persons affiliated with the adviser.[6] Congress found that numerous practices in the management of such funds adversely affected the national public interest and the interest of investors. Accordingly, Congress declared it to be the policy and purpose of the ICA to mitigate and eliminate those aspects of the conduct and administration of the funds which benefitted the managers and adversely affected the stockholders of the fund.[7]

The ICA provides that no more than 60% of a registered company's board of directors can be "interested persons" affiliated with the investment adviser.[8] Moreover, it gives the statutorily disinterested directors, usually referred to as "independent directors," certain powers to supervise management and auditing arrangements.[9] Thus,

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[6] See SEC, Report on the Study of Investment Trusts and Investment Companies, pt. 3, 1-49, 1922 (1940). See also Comment, Duties of the Independent Directors in Open-End Mutual Funds, 70 Mich.L.Rev. 696, 701 (1972).

[7] See 15 U.S.C. § 80a-1 (1970).

[8] See 15 U.S.C. §§ 80a-10, 80a-2(a)(3), (19) (1970).

[9] See generally Comment, Duties of the Independent Director in Open-End Mutual Funds, 70 Mich.L.Rev. 696 (1972).

section 15(c) of the ICA, 15 U.S.C. § 80a-15(c) (1970), imposes on the disinterested directors the duty to review and approve the contracts of the investment adviser and the principal underwriter; section 16(b), 15 U.S.C. § 80a-16(b) (1970), provides that the statutorily disinterested directors will appoint other disinterested directors to fill vacancies resulting from the assignment of the advisory contracts; and section 32(a), 15 U.S.C. § 80a-31(a) (1970), requires that the accountants who prepare the investment company's Securities and Exchange Commission financial filings be selected by the statutorily disinterested directors. We conclude, therefore, that the statutes were designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Congress has not been satisfied, moreover, that the presence of disinterested directors who observe their duties will be sufficient protection to the stockholders, as it has specifically provided in section 36(b) that shareholders may sue derivatively to recover excessive fees to the adviser and the prinicpal underwriter. See 15 U.S.C. § 80a-35(b) (1970). Section 36(b) was enacted as a part of the 1970 amendments, which resulted in part from the Senate report which indicates that the mere presence of disinterested directors on the boards of mutual funds was not sufficient to protect funds against overreaching investment advisers.[10]

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[10] See 1970 U.S.Code Cong. & Admin.News, pp. 4897, 4901. In 1970 both the ICA and the IAA were substantially amended. See Act of December 14, 1970, Pub.L. No. 91-547, 84 Stat. 1413.

We have been sensitive to the need for protection of the public interest in accordance with the views of Congress. Thus, in *Galfand* v. *Chestnutt*, 545 F.2d 807 (2d Cir. 1976), we found that the investment adviser had abused its position of trust by securing a favorable modification of its advisory contract without fully disclosing to the fund's directors the ramifications of the changes. Writing for the panel, Chief Judge Kaufman observed that, "[t]he relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. The typical fund ordinarily is only a shell, organized and controlled by a separately owned investment company adviser, which selects its portfolio and administers its daily business." Id. at 808. See also *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir. 1977).

Moreover, in many instances where no specific authority is granted by statute the courts have inferred that stockholders may bring suit. See, e.g., *Abrahamson* v. *Fleschner*, 568 F.2d 862 at 873 (2d Cir. Feb. 25, 1977) and cases cited therein. It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.

In the ordinary routine of running an investment trust, the disinterested directors must constantly deal with interested directors in a spirit of accommodation. Indeed, they are compelled for the most part to rely on the information and expert advice provided by the adviser and the majority directors.[11] The continued service of the statutorily disin-

[11] See Comment, supra note 9, at 702.

terested directors, for which in this case they were paid from $11,000 to $13,000 *per annum*[12], depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection. It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned.[13] Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuation of nonfrivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties. Of course here we do not reach the question of whether a court should defer to the decision of statutorily disinterested directors of an investment company to terminate a shareholder derivative suit which the court finds to be frivolous.

Our conclusion makes it unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent to determine that the litigation

[12] In addition to their role as directors of the Fund, each of the five minority directors served on the boards of five other Anchor affiliated funds, and all but one of the directors sat on a sixth Anchor related board.

[13] See *Fogel* v. *Chestnutt*, 533 F.2d 731, 750, (2d Cir. 1975); Nutt, A. Study of Mutual Fund Independent Directors, 120 U.Pa.L. Rev. 179, 216 (1971).

be ended.[14] We have no doubt that the five minority directors acted in good faith in all that they did.

Reversed and remanded for further proceedings.

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[14] Similarly, the plethora of cases cited by counsel dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite. We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser, we need not reach questions of the exercise of similar power by directors of other types of corporations. Moreover, none of these cases involves the situation here, where the terminating directors owe their position as directors to the defendants in the suit.

COMPLAINT

Complaint

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs,

against

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION, and FUNDAMENTAL INVESTORS, INC.,

Defendants.

PLAINTIFFS DEMAND TRIAL BY JURY

Plaintiffs allege on information and belief, except as to Paragraphs 2 and 6, which are alleged upon knowledge by each of said plaintiffs:

1. The jurisdiction of this Court over this action is based upon Section 44 of the Investment Company Act of 1940 (15 U.S.C. § 80a-43), Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-14) and principles of pendent jurisdiction.

2. Plaintiff Howard M. Lasker is, and at the time of the transactions complained of was, the beneficial owner of shares of Fundamental Investors, Inc. (the "Fund").

Plaintiff Irving Goldberg is, and at the time of the transactions complained of was, the record owner of shares of the Fund. Plaintiffs bring this action derivatively on behalf and in the right of the Fund.

3. The Fund is, and at the time of the transactions complained of was, a corporation organized under the laws of the State of Delaware and a registered investment company under the Investment Company Act of 1940.

4. Defendant Anchor Corporation (the "Adviser") is, and at the time of the transactions complained of was, a corporation organized under the laws of the State of Delaware and a registered investment adviser under the Investment Advisers Act of 1940.

5. Defendants Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey C. Hopkins, S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips and Jeptha H. Wade (the "Fund directors") were directors of the Fund at all times mentioned.

6. This action is not brought collusively to confer upon this Court jurisdiction which it otherwise would not have and plaintiffs will fairly and adequately represent the interests of the Fund and its stockholders in enforcing the Fund's rights.

7. (a) No demand has been made by the plaintiffs upon the Board of Directors of the Fund to institute this action against the individual defendants and the Adviser because the Fund's Board of Directors is dominated and controlled by the Adviser and the individual defendants continue to be a majority of the Fund's Board of Directors and they have

participated, cooperated and aided and abetted in the wrongful acts, transactions and delinquencies complained of. No action could or would be permitted to be instituted by the Fund without the consent of the Fund directors. The Fund's Board of Directors for a considerable time has been fully aware of the wrongful acts herein alleged and has nevertheless failed to take action. Consequently, any demand upon the Fund's Board of Directors would be futile and useless and any such action that would be instituted by the Board of Directors on behalf of the Fund would be friendly to the defendants, would not be diligently prosecuted and would be hostile to the interests of the Fund and its stockholders.

(b) No demand has been made upon the stockholders of the Fund to institute this action on behalf of the Fund because under applicable law and the certificate of incorporation and by-laws of the Fund, its directors and officers are vested with the management of the Fund, including the institution of all actions on behalf of the Fund, and the stockholders as a body cannot by resolution compel the directors to institute suit on behalf of the Fund. A resolution by the stockholders of the Fund directing the institution of this action would be futile and useless because the prosecution of the action would be placed in the control of the Fund's Board of Directors, the majority of whom are defendants and who had knowledge of and participated, cooperated and aided and abetted in the wrongs alleged herein. Furthermore, the stockholders of the Fund are very numerous and the solicitation of proxies from such a large number of stockholders would place an unreasonable and useless burden and expense on plaintiffs, and extended delays would result which would be harmful and seriously prejudicial to the prosecution of this action.

FIRST CLAIM FOR RELIEF

8. Plaintiffs repeat and reallege Paragraphs 1 through 7 of the Complaint.

9. This claim arises under Section 36 of the Investment Company Act of 1940.

10. On the following dates and in the amounts indicated, the Fund purchased interest bearing commercial paper of Penn Central Transportation Company ("Penn Central") in the Southern District of New York from Goldman, Sachs & Co. ("Goldman, Sachs"), which acted as principal, by use of the mails and the means and instrumentalities of interstate commerce:

Date of Purchase	Amount of Purchase
November 28, 1969	$ 5,000,000
December 2, 1969	5,000,000
December 4, 1969	5,000,000
December 8, 1969	5,000,000
	$20,000,000

11. At all relevant times the Fund directors were responsible for determining the basic investment policies of the Fund and the Adviser acted as investment adviser to the Fund and was responsible for making recommendations to the Fund with respect to purchase and sale of all investments, including commercial paper. During 1969 the Adviser received, pursuant to its investment advisory contract, in excess of $4,500,000 from the Fund for investment supervisory and corporate administrative services and in excess of $300,000 in net sales commissions as principal underwriter of the Fund's shares.

12. In making the purchases alleged in Paragraph 10, the Fund directors and the Adviser relied solely and exclusively on Goldman, Sachs and made no independent investigation of the financial condition of Penn Central or the quality of its commercial paper including, where feasible, among other things, the following: examination and analysis of quarterly or more frequent financial statements; calculation of debt-equity ratios; obtaining of lists of open bank lines of credit and inquiry as to whether any such were used; calculation of the ratio of current assets to current liabilities; examination and analysis of debt position to check for defaults; review of the appropriate Docket of the Interstate Commerce Commission with respect to the proposed issuance of commercial paper by Penn Central; verifying creditworthiness of issuer with custodian bank; inquiry with respect to maximum amount of bank lines of credit ever used; examination of percentage of commercial paper outstanding backed by usable lines of credit; obtaining cash flow statement, if available. In failing to make the foregoing investigation, the Adviser failed to meet its responsibility as the Fund's investment adviser, for which investment management and advice it received the very substantial compensation set forth in Paragraph 11. The Fund directors knew or should have known of, and acquiesced in, the failure by the Adviser to meet its responsibility and failed to meet their responsibilities as members of the Fund's Board of Directors.

13. If the Fund directors and the Adviser had made an independent investigation of the financial condition of Penn Central and the quality of its commercial paper in connection with the Fund's purchase of Penn Central commercial paper (including a review of material available in

the public press), they would have learned at least the following material adverse facts.

(a) The commercial paper of Penn Central was not prime quality commercial paper;

(b) Goldman, Sachs had made inadequate independent investigation of the financial condition and affairs of Penn Central and was not continually reviewing the same to ascertain whether Penn Central commercial paper was of prime quality or to evaluate the advisability of purchases of said commercial paper by the Fund;

(c) Penn Central had for some time been facing severe cash shortages and difficulties in obtaining financing to meet its operating expenses, improvement costs and debt maturities;

(d) Penn Central had for some time been unable to obtain long-term financing and had, since at least as early as 1968, become almost completely dependent upon short-term, high interest financing, had been required to maintain substantial compensating balances at its lending banks and had no present prospects for obtaining long-term financing;

(e) Penn Central had virtually exhausted all possibilities to obtain bank loans, had already pledged virtually all of its assets to its bank creditors and had no assets to pledge or otherwise use to obtain further loans or financing or to cover or meet its commercial paper obligations;

(f) Penn Central was using the funds which it obtained from the sales of its commercial paper to

refinance its debt maturities rather than for its current operating expenses;

(g) Penn Central was undergoing extraordinarily large and rapidly increasing operating losses and working capital deficits;

(h) During 1970 Penn Central would have to have available far in excess of \$200,000,000 merely to meet debt maturities and interest costs and would have to raise other substantial and unavailable sums to meet its other anticipated expenses;

(i) In an application by Penn Central to the Interstate Commerce Commission for approval to issue commercial paper, the Interstate Commerce Commission and its staff had expressed serious concern over the heavy dependence of Penn Central upon short-term financing;

(j) Penn Central had no firm commitments by commercial banks to assure that it would have sufficient funds to redeem its outstanding commercial paper at maturity, and did not have bank lines of credit sufficient for that purpose;

(k) Most banks were at or near their legal or practical lending limits with respect to Penn Central and were looking to reductions of their loans rather than increases and it was highly doubtful that Penn Central could obtain authorization from the Interstate Commerce Commission to issue additional commercial paper beyond the \$200,000,000 then authorized;

(l) In November 1969 Penn Central reported a loss of approximately \$40,200,000 for the first nine

months of 1969 as compared to a loss of approximately $13,800,000 for the comparable period in 1968;

(m) On or about November 29, 1969, the Board of Directors of Penn Central's parent company omitted that corporation's regular fourth quarter dividend.

14. On June 21, 1970 Penn Central filed a petition for reorganization under Section 77 of the Bankruptcy Act (11 U.S.C. § 205).

15. The Penn Central commercial paper held by the Fund was not paid at maturity and is presently in default and the Fund has not received any payment with respect to such commercial paper up to the date of this Complaint, thereby resulting in a loss to the Fund of $20,000,000 plus accrued interest.

16. By reason of the foregoing, defendants, in contravention of Section 36 of the Investment Company Act of 1940, engaged in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund.

Second Claim For Relief

17. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

18. This claim arises under Section 206 of the Investment Advisers Act of 1940.

19. By reason of the foregoing, the Adviser, in contravention of Section 206 of the Investment Advisers Act of

1940, by use of the mails and the means and instrumentalities of interstate commerce, engaged in transactions, practices and a course of conduct which operated as a fraud and deceit upon the Fund and engaged in acts, practices and a course of conduct which were fraudulent.

Third Claim For Relief

20. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

21. By reason of the foregoing, the defendants violated their common law fiduciary duty to the Fund and are jointly and severally liable and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the acts, transactions and delinquencies complained of.

Fourth Claim For Relief

22. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

23. By reason of the foregoing, the Adviser breached its investment advisory contract with the Fund and the Fund directors participated and aided and abetted in the breach of said investment advisory contract in that the Adviser failed to make an independent investigation of the financial condition of Penn Central and the quality and safety of its commercial paper and the Fund directors acquiesced in such failure, thereby damaging the Fund as alleged, and the defendants are jointly and severally liable

and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the breach of the investment advisory contract complained of.

Fifth Claim For Relief

24. Plaintiffs repeat and reallege Paragraphs 1 through 7 and Paragraphs 10 through 15 of the Complaint.

25. This claim arises under Section 36 of the Investment Company Act of 1940.

26. From November 28, 1969 to June 21, 1970, the date of the filing of a petition for the reorganization of Penn Central under Section 77 of the Bankruptcy Act, the financial condition of Penn Central worsened steadily and Penn Central commercial paper became an increasingly poor investment.

27. During the period from November 28, 1969 to June 21, 1970, the Adviser and the Fund directors failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn Central and the quality and safety of its commercial paper.

28. If such investigation and review had been made (including a review of material available in the public press), the Adviser and the Fund directors would have learned at least the material adverse facts, among others, set forth at subparagraphs (a)-(m), inclusive, of Paragraph 13 of this Complaint as well as at least the following material adverse facts:

(a) Penn Central's losses for 1969 had increased to approximately $56,300,000 from approximately $5,100,000 for 1968;

(b) The losses of Penn Central for the first quarter of 1970 were approximately $62,700,000;

(c) On or about February 12, 1970, Penn Central repurchased at face value $10,000,000 of its commercial paper from Goldman, Sachs;

(d) Penn Central had virtually exhausted its ability to obtain short term financing in the United States;

(e) Penn Central and its parent company had begun to borrow heavily at high interest rates in Europe from borrowers who were relatively unsophisticated about Penn Central;

(f) On or about April 22, 1970, there commenced a rapid run on Penn Central commercial paper and it became virtually impossible for Goldman, Sachs to resell Penn Central commercial paper as it became due;

(g) On or about May 9, 1970, high Penn Central officials met with the Secretary of the Treasury with respect to emergency Government assistance for the failing railroad;

(h) On or about May 15, 1970 Standard and Poor's reduced the credit rating of Penn Central's parent company from BBB to BB.

29. During the period from November 28, 1969 to June 21, 1970, the Fund directors failed in their obligations to make adequate attempts to resell (as did Goldman, Sachs as referred to in subparagraph (c) of Paragraph 28) the Penn Central commercial paper held by the Fund and the Adviser failed to advise the Fund of the advisability of making such attempts.

30. During the period from November 28, 1969 through June 21, 1970, the Adviser, pursuant to its investment advisory contract, continued to be compensated by the Fund for investment supervisory and corporate administrative services at an annual rate in excess of $4,500,000 and continued to receive net sales commissions as principal underwriter of the Fund's shares at an annual rate in excess of $300,000.

31. By reason of the foregoing, defendants, in contravention of Section 36 of the Investment Company Act of 1940, engaged in acts and practices constituting gross misconduct and a gross abuse of trust in respect of the Fund.

Sixth Claim For Relief

32. Plaintiffs repeat and reallege Paragraphs 1 through 7, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

33. This claim arises under Section 206 of the Investment Advisers Act of 1940.

34. By reason of the foregoing, the Adviser, in contravention of Section 206 of the Investment Advisers Act of 1940, by the use of the mails and the means and instrumentalities of interstate commerce, engaged in transactions, practices and a course of conduct which operated as a fraud and deceit upon the Fund and engaged in acts, practices and a course of conduct which were fraudulent.

Seventh Claim For Relief

35. Plaintiffs repeat and reallege Paragraphs 1 through 7, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

36. By reason of the foregoing, the defendants violated their common law fiduciary duty to the Fund and are jointly and severally liable and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the acts, transactions and delinquencies complained of.

Eighth Claim For Relief

37. Plaintiffs repeat and reallege Paragraphs 1 through 7, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

38. By reason of the foregoing, the Adviser breached its investment advisory contract with the Fund and the Fund directors participated and aided and abetted in the breach of said investment advisory contract in that the Adviser failed to commence a thorough and adequate investigation of, and keep under continuous review, the financial condition of Penn Central and the quality and safety of its commercial paper and the Fund directors acquiesced in such failure, thereby damaging the Fund as alleged, and the defendants are jointly and severally liable and accountable to the Fund for all loss and damage which it has suffered and will suffer by reason of the breach of the investment advisory contract complained of.

Ninth Claim For Relief

39. Plaintiffs repeat and reallege Paragraphs 1 through 17, Paragraphs 10 through 15 and Paragraphs 26 through 30 of the Complaint.

40. This claim arises under Section 13(a)(3) of the Investment Company Act of 1940.

41. The Fund's registration statement filed with the Securities and Exchange Commission pursuant to Section 8(b) of the Investment Company Act of 1940 states, as a fundamental policy, that the Fund may not hold more than 10% of the securities (voting and non-voting) of any one issuer.

42. During the period from November 28, 1969 to June 21, 1970, the date of the filing of a petition for reorganization of Penn Central under Section 77 of the Bankruptcy Act, the outstanding commercial paper of Penn Central dropped from $200,000,000 to approximately $82,000,000.

43. The $20,000,000 of Penn Central commercial paper held by the Fund constituted the holding of more than 10% of the securities of a single issuer.

44. The Fund directors and the Adviser failed in their responsibility to ascertain that the Fund's holding of Penn Central commercial paper deviated from the fundamental policy set forth in the Fund's registration statement filed with the Securities and Exchange Commission pursuant to Section 8(b)(2) of the Investment Company Act of 1940.

45. By reason of the foregoing, the defendants, in contravention of Section 13(a)(3) of the Investment Company Act of 1940, caused the Fund to deviate from the fundamental policy recited in its registration statement filed with the Securities and Exchange Commission pursuant to Section 8(b)(2) of the Investment Company Act of 1940.

Wherefore, plaintiffs demand judgment against the defendants as follows:

(a) That the Fund directors and the Adviser be required to account to the Fund for all loss and

damage sustained and to be sustained by the Fund as a result of the wrongful acts, transactions and delinquencies complained of.

(b) That plaintiffs recover the costs and disbursements of this action including reasonable fees to plaintiffs' attorneys and accountants.

(c) That plaintiffs have such other and further relief as may be just and proper.

Aranow, Brodsky, Bohlinger,
Benetar, Einhorn & Dann

By s/ Herbert A. Einhorn
(A Member of the Firm)
Attorneys for Plaintiffs
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469 Fifth Avenue
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(212) 889-1470

(Verification)

PAPERS ON MOTION TO DISMISS

Affidavit of Roger T. Wickers, Sworn to January 27, 1975 in Support of Motion to Dismiss

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

———————0———————

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

———————0———————

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

ROGER T. WICKERS, being duly sworn, deposes and says:

1. I am Senior Vice President of Fundamental Investors, Inc. ("Fundamental"), the party on whose behalf this derivative action is allegedly brought, and I submit this affidavit in support of the motion by Fundamental to dismiss this action.

2. I have personal knowledge of the facts set forth in this affidavit, and I bring them to the attention of this Court to supplement the principal moving affidavit of Leon T. Kendall, sworn to January 23, 1975.

3. Fundamental is an open-end investment company (commonly known as a "mutual fund") registered under the Investment Company Act of 1940.

4. Anchor Corporation ("Anchor") is the investment adviser to Fundamental.

5. On November 26, 1969 Fundamental, which had a portfolio at that time worth approximately one billion dollars, purchased from Goldman, Sachs & Co., a commercial paper dealer, $20 million of 270-day notes of Penn Central Transportation Company as a short-term investment of unemployed cash.*

6. On June 21, 1970 Penn Central Transportation Company filed a Petition for Reorganization under the federal bankruptcy laws, and the notes were not paid at maturity, nor have they been paid to date. Penn Central Transportation Company is still in the process of being reorganized under the jurisdiction of Honorable John R. Fullam, United States District Judge for the Eastern District of Pennsylvania.

7. On November 4, 1970 Fundamental initiated an action, with three other plaintiffs,** in the United States District Court for the Southern District of New York against Goldman, Sachs & Co. ("the *Welch* action") for rescission of their purchases of the notes of Penn Central Transportation Company. The Board of Directors of Fundamental has kept this matter under continuous review since that time.

8. Nearly three years after the purchase of the Penn Central Transportation Company commercial paper by Fundamental, two stockholders of Fundamental commenced

* The purchase was actually made in four $5,000,000 amounts on November 26, December 2, 4 and 8, 1969.

** The three other plaintiffs were Welch Foods Inc., C. R. Anthony Company and Younker Brothers.

the instant derivative action ("the *Lasker* action") allegedly on behalf of Fundamental. On July 30, 1973, on motion of all defendants, Judge Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental in the *Welch* action.

9. On July 9, 1974 the claims of Fundamental in the *Welch* action were settled as follows: Goldman, Sachs & Co. took back the notes, paid Fundamental $5,250,000 in cash and assigned to Fundamental a 73.75% interest in the proceeds of the $20 million of notes in the reorganization proceedings.

10. On July 24, 1974, following the settlement of the claims of Fundamental in the *Welch* action, the Board of Directors of Fundamental retained Honorable Stanley H. Fuld, former Chief Judge of the State of New York as Special Counsel to advise and consult with it regarding this matter.

11. On December 18, 1974 and January 6, 1975, the Board of Directors of Fundamental met at special meetings. Following the deliberations, described in detail in the Kendall affidavit, by a wholly disinterested quorum consisting of five members of the Board of Directors,* none of whom was a director at the time of the events complained of and none of whom is a defendant in the *Lasker* action, the Board of Directors, acting solely by these five wholly disinterested persons, resolved that it was not in the best interests of the shareholders of Fundamental for the *Lasker* action to

* The five wholly disinterested directors are: Leon T. Kendall, Louis F. Laun, Mary S. O'Connor, Beryl Robichaud and William J. Stephens.

continue against Anchor and the other defendants, and instructed litigation counsel to Fundamental in this action (Messrs. Seward & Kissel) to move to dismiss this action.

All other defendants have joined in this motion by Fundamental.

CONCLUSION

The Board of Directors of Fundamental, acting by a wholly disinterested quorum, has determined that in its business judgment, this action allegedly brought on behalf of Fundamental is contrary to the best interests of Fundamental and its shareholders. Accordingly, this action should be dismissed.

s/ ROGER T. WICKERS

Sworn to before me
January 27, 1975

Affidavit of Leon T. Kendall, Sworn to January 23, 1975, in Support of Motion to Dimiss

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

———o———

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

———o———

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

LEON T. KENDALL, being duly sworn, deposes and says:

1. I am a director of Fundamental Investors, Inc. ("Fundamental"), the mutual fund on whose behalf this derivative action has allegedly been brought. I am fully familiar with the facts set forth below and make this affidavit in support of Fundamental's motion to dismiss this action. The basis of this motion is that by unanimous vote the Board of Directors of Fundamental (acting by a wholly disinterested quorum) determined that this action is contrary to the best interests of the shareholders of Fundamental.

2. I attended the meeting of the Board of Directors of Fundamental held on July 24, 1974. Following a discussion of the settlement of Fundamental's action against Goldman, Sachs & Co. ("the *Welch* action"), the Board of Directors reviewed the status of this action. The Board of Directors determined that the five directors who (a) are not affiliated in any way with the investment adviser, Anchor Corporation ("Anchor"), (b) were not directors at the time of the events alleged in the complaint and (c) are not defendants in this action ("the five disinterested directors") would.

acting as a quorum pursuant to the by-laws, constitute the Board of Directors to decide what position Fundamental should take regarding this action.

The Five Disinterested Directors

3. For the Court's information, the following is a brief description of the five disinterested directors, together with the year in which each became a director:

Name	Year Elected to Board	Background
Leon T. Kendall	1974	President of Mortgage Guaranty Insurance Corporation, Milwaukee, Wisconsin (a New York Stock Exchange listed company with assets approaching $800,000,000). Vice President and Economist of the New York Stock Exchange from 1964 to 1967. President of the Association of Stock Exchange Firms from 1967 to 1972 and thereafter President of The Securities Industry Association until 1974.
Louis F. Laun	1971	Deputy Administrator of the Small Business Administration, Washington, D.C.; until 1971, Vice President of Celanese Corporation, manufacturer of synthetic fibers.
Mary S. O'Connor	1972	Director and Member of the Executive and Trust Committees of the Central Home Trust Company of Elizabeth, New Jersey, since 1959; Assistant Vice President of International Business Machines Corporation from 1943 to 1947.
Dr. Beryl Robichaud	1973	Senior Vice President, McGraw-Hill, Inc., New York, New York. Director, Aetna Life and Casualty Corporation.
William J. Stephens	1973	Director, Jones and Laughlin Steel Corporation, Pittsburgh, Pennsylvania; until 1972, Chairman and Chief Executive Officer of Jones and Laughlin Steel Corporation. Director, Equitable Gas Company, Pittsburgh.

Retention of Chief Judge Fuld as Special Counsel

4. To assist in our consideration, at the July 24 meeting, we five decided to retain special counsel. Pursuant to that decision, after reviewing his background and qualifications, we retained Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to review all of the relevant aspects of this matter and to analyze the pertinent facts and relevant law and authorities. A copy of a biographical sketch of Chief Judge Fuld is attached as Exhibit A.

5. After several months of investigation, Chief Judge Fuld reported the results of his analysis of the facts and law in a memorandum dated December 5, 1974, a copy of which is attached as Exhibit B. Chief Judge Fuld reported that he had reviewed the complaint in this action and the relevant documents and depositions in the *Welch* action. He had also reviewed the files of Fundamental and Anchor relating to the purchase of the Penn Central commercial paper, and interviewed officers of Fundamental and Anchor who had knowledge of the relevant events. In addition, Chief Judge Fuld reviewed the corporate documents of Fundamental, studied the applicable statutes and regulations and conducted the necessary legal research.

6. Chief Judge Fuld advised us that

> "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper." (p. 2).

7. After receiving Chief Judge Fuld's December 5, 1974 opinion, each of us carefully reviewed it and several of us had questions regarding the subjects covered in the opinion and the alternatives which were available to the directors of Fundamental.

8. In response to questions raised by the five disinterested directors and on further review of his own, on December 18, 1974 Chief Judge Fuld delivered a supplemental analysis and opinion to the Board. A copy of his supplemental analysis and opinion is annexed as Exhibit C. Chief Judge Fuld had advised in his December 5 memorandum that it was up to the five disinterested directors, in the exercise of their discretion and business judgment, to determine what course Fundamental should follow. As previously noted, Chief Judge Fuld had advised us that in his opinion there was no violation of law by Anchor or by the directors of Fundamental. In his supplemental opinion, he went on to add that even if there were a possible claim, Fundamental did not necessarily have to prosecute that claim: he advised us that whether or not a corporation seeks to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management and is left to the discretion of the directors.

The December 18, 1974 Meeting:
Exploration of the Facts and Law

9. After receiving Chief Judge Fuld's supplemental opinion of December 18, 1974, the five disinterested directors met alone in a series of special meetings devoted exclusively to this subject. In that first special meeting I was designated to be Chairman of the five disinterested directors. We reviewed the supplemental opinion and discussed further the questions each of us had with respect to the facts, the law and the alternatives available. We also determined the procedure we would follow in conducting our inquiry, including the subjects to be dealt with, the order in which we would deal with them and whom we would question.

10. Following our private discussion, we invited the following persons to join the special meeting for the purpose of responding to our questions: Chief Judge Fuld; John R. Haire, Chairman and Chief Executive of Anchor; Donald L. Kemmerer and Charles F. Phillips, who are, and at the time of the events complained of, were unaffiliated directors of Fundamental; and Eugene P. Souther, Esq., litigation counsel to Fundamental in this action. As Chairman, I presided at that meeting and Mr. Souther served as Secretary. Minutes of that special meeting are annexed as Exhibit D.

11. The attached minutes show the order in which we proceeded in that meeting and the substance of our discussions. Each of us had given substantial consideration to the issues in preparation for the meeting and we pursued our questions in what I believe was a thoughtful and searching fashion.

12. The five disinterested directors asked Chief Judge Fuld, among other things, for his opinion as to (a) the merits of each of the claims made in this action, (b) whether Anchor had followed proper procedure under the circumstances at the time in determining to purchase and retain the Penn Central commercial paper, (c) the standards the

five disinterested directors should apply in determining what course of action to pursue, and (d) the alternatives available to the Board. Chief Judge Fuld gave us his opinion on these subjects and emphasized that in making our decision we should exercise our good faith business judgment as to what was in the best interests of the shareholders of Fundamental.

13. Our questions to Mr. Souther pertained to the practical implications of each alternative. We discussed the nature and extent of pre-trial discovery and trial preparation to be expected, the cost, and the business interruption that might be experienced by Anchor and how that might adversely affect the interest of the shareholders of Fundamental. We also discussed the effect, if any, of the earlier decision of the Board of Directors to settle its case against Goldman, Sachs, and the subsequent jury award to the remaining plaintiffs in the *Welch* action.

14. We then interrogated John Haire. Our discussions with him are summarized in the annexed minutes and, to avoid repetition, will not be detailed here. Suffice it to say that the five disinterested directors had thought long and hard about the questions before them. All of us had carefully reviewed Chief Judge Fuld's thoughtful analysis. So armed, and with the advantage of hindsight, we critically examined the decision to purchase the Penn Central commercial paper, the information available to Anchor at the time, the consideration Anchor gave before purchasing that paper, the procedure Anchor followed in making the investment, the information available to the Board of Directors at the time with respect to that purchase and other purchases of commercial paper, the identity of other "sophisticated investors" who had purchased Penn Central commercial paper during the relevant period, the identity of those purchasers of such paper who held it at the time of the Penn Central reorganization, the anticipated effect on the shareholders of Fundamental if this action were to be prosecuted either under the control of Fundamental or under the control of the two shareholders who brought it, the anticipated effect on the investment adviser from the continued prosecution of the action and how that would affect Fundamental's shareholders, and the ability of Anchor to respond in damages should a judgment against it be obtained.

15. After excusing Messrs. Phillips, Kemmerer and Haire, we five continued our discussion with Chief Judge Fuld, reviewing the subjects which had been considered during the earlier part of the meeting and the criteria we should apply in reaching our decision.

16. When there were no more questions, we excused Chief Judge Fuld and Mr. Souther. In that private portion of the meeting we agreed that we wished to give further consideration to the subject and adopted a procedure for that consideration. Each director would give further separate thought to the matter and convey any additional questions to me for response. I was to secure replies to these questions through our special counsel and litigation counsel. We agreed not to have any contact with anyone affiliated with Anchor until we had reached our decision.

December 18, 1974—January 6, 1975: Further Reflection by the Disinterested Directors

17. During late December and early January I personally spoke by telephone with each of the other four dis-

interested directors and gathered the questions they wanted answered. Indicative of the consideration we were each giving to the matter is the letter written to each of us by William J. Stephens on December 31, 1974. A copy of that letter is attached as Exhibit E.

18. I reviewed the questions for Chief Judge Fuld in a conference call with him and Mr. Souther on January 3, 1975. The essence of that conversation was to reconfirm that we were to make our decision, whatever it was to be, in the exercise of our good faith business judgment as to what was in the best interests of the shareholders of Fundamental. Because the telephone connection at times was not satisfactory, I thereafter personally spoke with Chief Judge Fuld and repeated the discussion.

The Meeting of January 6, 1975:
The Vote to Dismiss

19. The second special meeting of the Board of Directors to review this subject was held on January 6, 1975. The other directors present were: Louis F. Laun, Dr. Beryl Robichaud and William J. Stephens. Mrs. Mary S. O'Connor was abroad, but she and I had spoken by telephone and she had told me her decision as to the action Fundamental should take. In addition, Mr. Souther was also present to act as Secretary of the meeting.

20. Following the review and approval of the minutes of the first special meeting, I reported to the Board the events that had transpired since our last meeting, including my telephone conversation on January 3 with Chief Judge Fuld. Mr. Souther then replied to certain questions from Board members. The questions and his answers are summarized in the minutes of that special meeting, a copy of which is attached as Exhibit F. We all confirmed that we had not communicated with any officer or employee of Anchor since the December 18, 1974, special meeting.

21. We then reviewed in detail each of the alternatives available to Fundamental. Our consideration is summarized in the minutes of the meeting. Our overriding and only consideration was what course was in the best interests of the shareholders of Fundamental.

22. We decided that the prosecution of this action was contrary to the best interests of the shareholders of Fundamental and that counsel should be directed to seek to dismiss the action. Among the factors we considered were:

(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;

(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative

but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash;

(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

(g) To take no position at all and thereby to allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent

statutes and regulations. Chief Judge Fuld had analyzed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found not to be liable to Fundamental; and

(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce.

23. After several hours of consideration, on motion of Mr. Louis F. Laun, seconded by Dr. Beryl Robichaud, the five disinterested directors (Mrs. O'Connor's vote being cast by me in accordance with her instructions to me*) unanimously decided to instruct counsel to move to dismiss the action as being contrary to the best interests of the shareholders of Fundamental.

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* Mrs. O'Connor reaffirmed her vote in the presence of all of us at a special meeting held for that purpose on January 22, 1975.

Affidavit of Kendall in Support of Motion to Dismiss

24. I therefore respectfully urge that this Court grant Fundamental's motion to dismiss the complaint.

s/ LEON T. KENDALL

Sworn to before me
January 23, 1975

Central commercial paper. At the outset I set forth the relevant facts which, despite the volume of material involved, may be summarized relatively briefly, and then consider the applicable law and the possible courses of action to be followed by the current Fund directors.

FACTS

The Fund has in recent years had large amounts of cash on hand, partly to be available to pay for securities

[1] The action by the Fund resulted in a settlement described below (*infra*, p. 9).

Exhibit B to Affidavit of Leon T. Kendall, sworn to January 23, 1975—Report of Stanley H. Fuld to Board of Directors of Fundamental Investors, Inc. dated December 5, 1974

(Letterhead of)
STANLEY H. FULD
425 Park Avenue
New York, N.Y. 10022

December 5, 1974

PRIVILEGED AND CONFIDENTIAL
Board of Directors
of Fundamental Investors, Inc.
Westminster at Parker
Elizabeth, New Jersey

Dear Sirs:

In November and December of 1969, Fundamental Investors, Inc. (the "Fund") purchased, in four separate lots, commercial paper of Penn Central Transportation Company ("Penn Central") from Goldman, Sachs & Co., in the aggregate amount of $20,000,000. On June 21, 1970, Penn Central filed a petition for reorganization under Section 77 of the Bankruptcy Act, and the commercial paper was not paid at maturity.

In February, 1973, a stockholders' derivative suit was brought against Anchor Corporation ("Anchor"), the Fund and the directors of the latter, based in substance on the claim that Anchor (the Fund's investment adviser) and the Fund's directors, in both the purchase and the retention of the Penn Central commercial paper, breached statutory and other obligations to the Fund by virtue of the fact that they "relied solely and exclusively on Goldman, Sachs and made no independent investigation of the finances of Penn Central or the quality of its commercial paper." (see p. 10 below).

You retained me as special counsel to advise you with respect to the future course of action to be followed in connection with the investment made by the Fund in the commercial paper of Penn Central.

I have reviewed the complaint in the derivative action, the relevant pleadings and depositions in the action entitled "*Welch Foods, Inc., et al.* v. *Goldman, Sachs & Co.*" brought by several parties, including the Fund, in the United States District Court for the Southern District of New York.[1] I have also had the files of the Fund and of its adviser, Anchor, relating to the purchase of that commercial paper reviewed. I have interviewed certain officers and employees of the Fund and have also had certain other officers and employees of the Fund interviewed, the Fund's constituent documents and the applicable statutes and regulations reviewed, and the necessary legal research conducted.

As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper. At the outset I set forth the relevant facts which, despite the volume of material involved, may be summarized relatively briefly, and then consider the applicable law and the possible courses of action to be followed by the current Fund directors.

Facts

The Fund has in recent years had large amounts of cash on hand, partly to be available to pay for securities

[1] The action by the Fund resulted in a settlement described below (*infra*, p. 9).

which the Fund managers found it desirable to purchase, and partly to be available for redemptions of Fund shares. During the latter part of 1965 Anchor, in order to increase the Fund's income, began to invest part of its temporarily idle cash in commercial paper. Responsibility for determining the amounts and maturities of the commercial paper purchased was placed in the office of the Fund's Treasurer, an employee of Anchor, who, in consultation with the various Fund managers and in the light of their projected purchases and of other cash needs of the Fund, decided how much money could be invested and for how many days.

Until the Fall of 1969 all commercial paper was purchased directly from among a group of eight issuers initially selected and approved by the Fund's Investment Committee.[2] In order to provide added liquidity in case of an unexpected need for cash by the Fund, the Treasurer insisted that each issuer agree to repurchase its paper from the Fund on demand. Purchases were made on virtually a daily basis, and officials of these issuers were in frequent telephone communication with the Fund's Treasurer, to negotiate the amounts, rates and maturities of paper which might be purchased by the Fund. Because he was continually purchasing paper from these companies, the Treasurer sought, through periodic questioning of these officials, review of published quarterly financial statements and inquiry of the Fund's bank custodian, to keep current on the credit status of the issuers, including the

[2] These eight companies were among the nation's major finance companies: General Motors Acceptance Corporation, Sears Roebuck Acceptance Corp., Montgomery Ward Credit Corp., J. C. Penney Credit Corporation (now J. C. Penney Financial Corporation), C.I.T. Financial Corporation, Commercial Credit Co., Ford Motor Credit Company, and Chrysler Financial Corporation.

extent of their outstanding commercial paper and of their unused bank lines.

From time to time Anchor was solicited by dealers who sought to sell to the Fund the commercial paper of industrial companies which did not sell their paper directly. Initially the paper sold by dealers offered substantially the same rate of return as that of direct issuers, but afforded less flexibility since the amounts, rates and maturities were fixed in advance whereas direct issuers could negotiate by telephone concerning these matters in order to meet the Fund's needs on a given date.

By the Fall of 1969 the rate differential, or rate of return spread, between dealer and direct paper had widened and the volume of paper and the variety of issuers offered by dealers increased to the point where the Fund's specific needs could be met. Arthur M. Kesselhaut, the Fund's Treasurer, brought this to the attention of John Haire, President of Anchor and of the Fund, and suggested that some dealer-placed commercial paper be purchased for the Fund. Haire approved the making of purchases from dealers, provided that certain guidelines were adhered to, similar to those followed in connection with purchases made directly from issuers. These were principally that the paper should bear a National Credit Office rating of "prime", no more than 10% of the outstanding paper of any issuer should be purchased, and the dealer should agree to repurchase the paper at the Fund's request. Kesselhaut discussed these requirements with representatives of Goldman, Sachs & Co., Lehman Commercial Paper Incorporated and A. G. Becker & Co. Incorporated, large dealers in commercial paper. In addition to the requirements stated above, he also insisted that the issuer be listed on a national securities exchange.

In the course of his discussions with Goldman, Sachs & Co., Kesselhaut was told that "each company they [Goldman, Sachs] represented was analyzed by a credit man at Goldman and that they had current financial information on every company they represented", the implication to him being that they "knew as much about the company as could be known". Kesselhaut understood that the two other dealers likewise made a current credit analysis of the companies whose paper they offered.

Several weeks after the Fund had begun to purchase paper from dealers, a representative of Goldman, Sachs & Co. called and offered Arthur Burach, Kesselhaut's assistant, $20 million of commercial paper of each of Penn Central and Chrysler Corporation, yielding 9% for 270 days (the maximum maturity of such paper). Kesselhaut was interested in the offer since he believed that interest rates had turned downward and would continue to fall, and he saw an opportunity to obtain a favorable rate of interest for a maximum period.

The approval of one of the three Fund managers was normally required in connection with each purchase of commercial paper, but because of the size and duration of the proposed purchase a conference was held, attended by Robert Daniel (chairman of Anchor's Investment Committee), Kesselhaut, and all three of the Fund managers, Robert Baines, Ronald Welburn and Bryant Hanley.[3] The discussion dealt with the principle of a purchase of 270-day paper as well as the availability of the cash required, and the two purchases were approved from this point of view. However, since not all the cash was immediately available

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[3] This is Kesselhaut's firm recollection. When interviewed, Baines and Welburn did not recall the meeting but acknowledged that they had either initialled approval of the purchase or had been told of the purchase shortly after it was made.

a schedule of purchases of Penn Central paper was adopted, with $5 million each to be purchased on four separate occasions at intervals of several days during the period November 28, 1969 to December 8, 1969. The $20,000,000 of Chrysler paper was likewise to be purchased in four equal $5,000,000 installments at about the same time. The financial condition of Penn Central was not discussed.

In making purchases of commercial paper from dealers, including the Penn Central paper, Kesselhaut believed that the Fund was sufficiently protected by (i) the "prime" rating given by the National Credit Office, one of the principal national rating organizations, (ii) the current credit analysis of each issuer which—based on representations by Goldman, Sachs & Co. and the other dealers—he believed was being performed by the dealer and formed the basis for the dealer's recommendation which he understood was implicit in its offer of the paper, (iii) the short-term nature of the investment, (iv) the fact that the issuer was a listed company whose name he recognized and the Fund managers were likely to also recognize, and (v) the likelihood that the Fund manager who approved the purchase would have alerted him to any seriously adverse information which he possessed about the issuer and which Kesselhaut himself might not have had. Because of this belief that the criteria established by Anchor provided sufficient protection—a belief buttressed by the financial community's general acceptance of commercial paper as a safe money-market instrument—Kesselhaut did not undertake, or have any other employee of Anchor perform, an independent analysis of the financial condition of issuers (including Penn Central) whose paper was offered to him by dealers, or any continuing review during the period in which the purchased paper was held by the Fund.

An article appeared in the May 18, 1970 issue of Barron's entitled "Beautiful Balloon? Rapid Growth of the Commercial Paper Market May Be Risky." The article did not mention Penn Central but expressed a general concern about the safety of commercial paper. Prompted by the article, the Fund sought to reduce the amount of its Penn Central and Chrysler commercial paper holdings by requesting Goldman, Sachs & Co. to repurchase half of both holdings, but Goldman, Sachs refused to repurchase the Penn Central paper.

As stated earlier, on June 21, 1970 a petition for reorganization of Penn Central was filed and its commercial paper was not paid at maturity.

The Action Against Goldman, Sachs & Co.

Late in 1970 the Fund and three other parties commenced a suit against Goldman, Sachs & Co. in which the Fund sought to recover its $20 million investment. The complaint alleged that, in connection with the sales of Penn Central commercial paper, Goldman, Sachs made numerous misstatements of material facts and omitted to state numerous material facts in violation of Section 12(2) and Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934, Section 352-c of the General Business Law of the State of New York, and the common law. In July, 1974, the Fund with the approval of its full Board of Directors settled its suit against Goldman, Sachs, and received $5,250,000 in cash; although the Fund also retained a 73.75% interest in the commercial paper which will make it whole if the notes are paid, the likelihood of any additional amounts being recovered as a result of this settlement is, at the present time, uncertain.

The three other plaintiffs in the action pressed the case to trial, and on October 9, 1974 a jury verdict was rendered in their favor for $3,000,000—the amount of their loss—plus interest. The jury, in reaching this verdict, must of necessity have concluded that Goldman, Sachs & Co. had withheld from its customers material non-public information concerning Penn Central.

The Derivative Action

In February, 1973 a derivative action entitled *Lasker et al.* v. *Burks et al.* was commenced by two shareholders of the Fund in the United States District Court for the Southern District of New York against Anchor and all of the directors of the Fund who were in office when the Penn Central paper was purchased and held. The Fund is a nominal defendant in the suit.

The complaint alleges that the Fund's purchases of the Penn Central paper were made by Anchor and the Fund's directors in sole reliance upon Goldman, Sachs & Co., without an independent investigation of Penn Central's financial condition or the quality of its commercial paper, and that such an investigation would have revealed a number of material adverse facts concerning Penn Central. The failure to make such an investigation is alleged to constitute a failure by Anchor to meet its responsibilities as the Fund's adviser; and it is also alleged that the Fund directors knew (or should have known) of, and acquiesced, in Anchor's failure to meet its responsibilities.

The complaint further recites that Anchor and the Fund directors failed to conduct a continuous review of the financial condition of Penn Central subsequent to the purchase of the paper—which review would have revealed a number of other material adverse facts—and that they failed to make adequate attempts to resell the paper.

It is asserted that the foregoing conduct was in violation of (i) Section 36 of the Investment Company Act of 1940, (ii) Section 206 of the Investment Advisers Act of 1940, (iii) the defendants' common law fiduciary duty to the Fund, and (iv) the terms of the advisory contract between Anchor and the Fund.

Finally, the complaint alleges that, when the amount of Penn Central commercial paper outstanding fell far below the initial $200,000,000, the Fund's holdings became much more than 10%, thus violating the Fund's fundamental policy that it would not "hold" more than 10% of the "outstanding securities" of a single issuer. This is claimed to constitute a violation of Section 13(a)(3) of the Investment Company Act of 1940.

The *Lasker* suit had been stayed pending the resolution of the suit brought by the Fund against Goldman, Sachs & Co., and the defendants (including the Fund) have not yet filed their answers. With the settlement in the latter suit concluded, the plaintiffs in the derivative suit have indicated their intention to carry it forward.

Discussion of Law

The complaint in the derivative action sets forth what appear to be all of the possible grounds for asserting liability against Anchor and the Fund directors for the loss which the Fund incurred because of its purchase of the Penn Central commercial paper (the "Penn Central loss"). Accordingly, in considering whether such liability exists and if so what action you should take in order to enforce it, I shall treat the various claims contained in the complaint.

Section 36 of the Investment Company Act

It is my opinion that neither Anchor nor any Fund director is liable to the Fund under Section 36 of the Investment Company Act of 1940 for the Penn Central loss.

Section 36—as it read at the time of the Fund's purchase of the Penn Central paper and until after the Penn Central bankruptcy proceedings were begun—authorized the Securities and Exchange Commission to bring an action against an officer, director or investment adviser of a registered investment company for "gross misconduct or gross abuse of trust in respect of "the investment company. Although Section 36 expressly provides for actions to be brought by the Commission, the courts have held that private suits may likewise be brought under its provisions. *Brown* v. *Bullock*, 194 F. Supp. 207 (S.D.N.Y. 1961), *aff'd*, 294 F.2d 415 (2d Cir. 1961); *Moses* v. *Burgin*, 445 F.2d 369 (1st Cir. 1971).

It seems clear—from the legislative history of Section 36, from a 1970 amendment to that section, and from judicial interpretation—that the use of the language "gross misconduct or gross abuse of trust" was deliberate and was designed to cover the type of conduct it explicitly describes and not mere negligence. Initially, Section 36 was drafted so as to make the proscribed conduct a criminal act, and the word "gross"' was "added to insure that only the more serious kinds of abuse", not mere negligence, "would be subject to sanctions" and render a person guilty of a crime. See Eisenberg & Phillips, "Mutual Fund Litigation—New Frontiers for the Investment Company Act," 62 Columbia Law Review 73, 99. Although the criminal sanctions were removed from the draft bill and replaced by the provision for actions brought by the Commission, the language describing the prohibited conduct remained. In *Rosenfeld* v.

Black, 445 F.2d 1337 (2d Cir. 1971), although the court held that an investment adviser to a mutual fund violated a fiduciary duty when it realized profits in connection with the appointment of a new adviser upon its recommendation, the court did not predicate its decision on Section 36, saying of that provision (p. 1346):

> "Words and remedies such as these were clearly addressed to highly reprehensible conduct [citation omitted]; we would not dream of suggesting, much less holding, that [the adviser's] actions were so culpable."

Indeed, an amendment to Section 36, made in December 1970—about a year after Anchor had purchased the Penn Central paper and some six months after the petition for its reorganization had been filed—serves to point up the distinction between Section 36's earlier standard of "gross" misconduct or "gross" abuse of trust and mere "nonfeasance of duty" or the like. The amendment added a new subsection "(b)" dealing with a breach of fiduciary duty in connection with the adviser's compensation, and at the same time deleted, from what became subsection "(a)", the words "gross misconduct or gross abuse of trust" and authorized Commission action where there is "a breach of fiduciary duty involving personal misconduct". In explaining the change, the Senate Committee on Banking and Currency wrote (Part F, Senate Report No. 91-184 to Accompany S. 2224 at 36):

> "* * * your committee does not intend to limit the Commission under this section to situations where an actual intent to violate the law can be shown or to acts of affirmative misconduct. In appropriate cases,

> ***nonfeasance of duty or abdication of responsibility*** would constitute a breach of fiduciary duty involving personal misconduct." (emphasis supplied)

Under these circumstances I conclude that even if—contrary to the opinion expressed herein—Anchor were deemed to have breached an obligation to the Fund in relying to the extent it did on Goldman, Sachs and on the National Credit Office, there was clearly no "gross misconduct or gross abuse of trust" in connection with the purchase of the Penn Central paper or its retention. The conditions adopted by Anchor for the purchase of dealer paper were believed by it to constitute a sufficient safeguard and, in reaching that conclusion, Anchor clearly acted reasonably and in good faith. Accordingly, in my opinion there is no liability under Section 36 on the part of Anchor or the directors of the Fund.

Section 206 of the Investment Advisers Act

It is also my opinion that neither Anchor nor any Fund director is liable under Section 206 of the Investment Advisers Act of 1940 for the Penn Central loss.

Section 206 is the anti-fraud section of that statute, corresponding with Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder. Section 206 reads, in pertinent part, as follows:

> "It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

> (1) to employ any device, scheme, or artifice to defraud any client or prospective client;
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> (2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;
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> * * *
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> (4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. . . ."

Section 206, like Section 17(a) and 10(b), does not expressly provide for civil liability. The courts have held that Sections 17(a) and 10(b) do give rise to civil liability, and very recently the District Court for the Southern District of New York expressly decided that Section 206 likewise confers a private right of action. *Bolger* v. *Laventhol, Krekstein, Horwath & Horwath*, CCH Fed. Sec. L. Rep. ¶ 94,618 (S.D.N.Y. 1974).[4]

The leading case under Section 206 of the Investment Advisers Act is *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), in which the Supreme Court held that the SEC could obtain an injunction requiring an investment adviser to disclose its practice of purchasing a security shortly before recommending a purchase to its clients for long-term investment and then selling at a profit immediately after the rise in price caused by the clients' purchases. The Court held that the absence of misrepresentations and an intent to injure was immaterial in an injunctive action by the Commission, but acknowledged that it "is not necessary in a suit for equitable or prophylactic relief to establish all the elements required in a suit for

[4] It should be noted that there are two recent decisions in other districts to the contrary.

monetary damages." 375 U.S. at 193. This distinction between the elements required in an injunctive suit and a damage action is also present in suits arising under Section 10(b).

My research has discovered no case which considers whether some form of fraudulent intent is essential to establish a private right of action under Section 206. In the absence of relevant authority under Section 206, it is likely that the courts would look to the analogous provisions of Section 10(b). The rule in the Second Circuit has long been that some element of scienter (i.e., knowledge or wilfulness) is essential in suits brought under Section 10(b), see *Fischman* v. *Raytheon Mfg. Co.*, 188 F.2d 783 (2d Cir. 1951), and the rule continues to be that "mere negligence is insufficient." *Leasco Corporation* v. *Taussig*, 473 F.2d 777, 785 (2d Cir. 1972); *Shemtob* v. *Shearson, Hammill & Co.*, 448 F.2d 442 (2d Cir. 1971). Moreover, the District Court for the Southern District in *Jones Memorial Trust* v. *Tsai Investment Services, Inc.*, 367 F. Supp. 491 (1973), recently considered Section 206 in a case in which the plaintiff sought damages for the diminution in value of its investment portfolio, claiming that the investment adviser had mismanaged "the process of researching and recommending investment transactions." The Court found no credible evidence of such mismanagement, stating in the course of its opinion (at 497):

> "The plain words of Section 206 of the Investment Advisers Act of 1940 make no mention of mismanagement, but speak solely and exclusively to concealment and misrepresentation."

In my opinion the element of fraudulent intent is necessary to establish a private cause of action under Section

206. Consequently, since for the reasons stated in my discussion of Section 36, there is a total absence of any such intent, it follows that there is no liability under Section 206 on the part of Anchor or the Fund directors.

Common Law Liability of Anchor for the Purchase

Concededly, Anchor did not make its own independent investigation of the financial condition of the issuers whose commercial paper was offered to it by selected dealers. It did, however, adopt a number of safeguards which it believed provided sufficient protection, particularly with respect to short-term money market instruments which had general acceptance in the financial community: (1) the paper had to be rated "prime" by National Credit Office, one of the principal rating organizations in the country, which presumably made an appropriate credit investigation; (2) the paper had to be recommended by a nationally known and respected investment banking firm, which had represented that it performed its own credit analysis of the issuer; and (3) the name of the issuer had to be recognized by the Fund Treasurer, and presumably by the Fund manager who also approved the purchase—the presumption being that, if either knew of any reason not to purchase the issuer's paper, he would so indicate. The Penn Central paper met these conditions; in connection with item (3) above, it should be noted that Penn Central was undoubtedly regarded generally as a mainstay of the nation's transportation system, and that its viability appeared unquestioned.

It is my opinion that, in purchasing the Penn Central paper under these circumstances, Anchor acted in good faith and in what should be regarded as a reasonable and prudent

manner. Accordingly, if the rule applicable to investment advisers is the same as that applicable to corporate directors (who must act "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like position"),[5] or as the rule applicable in general to trustees (who must use "such care and skill as a man of ordinary prudence would exercise in dealing with his own property"),[6] I believe it is clear that Anchor is not liable for the Penn Central loss on account of its purchase of the paper.

Because this rule refers to "ordinarily" prudent men or to men of "ordinary" prudence, it may be argued that it is inadequate in the case of an investment adviser which holds itself out as possessing special skills and competence. The rule generally applicable to persons who hold themselves out in this manner is that they must act with "the skill and knowledge normally possessed by members of [their] profession or trade";[7] similarly, if a trustee procures his appointment as trustee by representing that he has greater skill than that of a man of ordinary prudence, "he is under a duty to exercise such skill."[8] This is the rule which I believe should apply to the present case.

I have found no authority, however, which attempts to spell out precisely what this means in the case of an investment adviser.[9] In my opinion the test is one of reasonable-

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[5] See, e.g., N.Y. Business Corporation Law, § 717, N.J. Business Corporation Act § 14A:6-14.

[6] See, Restatement, Second, Trusts § 174.

[7] See, Restatement, Second, Torts § 299A.

[8] See, Restatement, Second, Trusts § 174.

[9] Indeed, in *Jones Memorial Trust* v. *Tsai Investment Services, Inc.*, 367 F. Supp. 491 (S.D.N.Y. 1973) the court stated that there was no evidence whatever produced at the trial as to what the standard of care is for a properly managed investment advisory service.

ness and prudence under the circumstances, and it is also my opinion that Anchor met that test, unless—~~which~~ appears unlikely—there can be developed substantial evidence that, in 1969, no investment adviser would or did rely in the purchase of commercial paper on the combination of factors relied on by Anchor.

In this connection it is noteworthy that among the purchasers of Penn Central paper after Anchor's purchases were American Express Company, California Institute of the Arts, Carnegie-Mellon University, Franklin Savings Bank, Getty Oil Corp., Marine Midland Bank, United States Trust Company of New York and University of Southern California.

I must point out, however, that in the absence of any authority, the contention can be made—as it is in the complaint in the derivative action—that since an investment adviser maintains an organization trained in financial analysis and performs such analysis of a very large number of companies, and since it is paid for investment management which presumably is based on this analysis, such an adviser should, as a matter of law, be held to a duty to make its own investigation and analysis, as well as its own independent decision based thereon for every purchase, not only of longer-term investments but also of short-term money market instruments such as commercial paper.

In support of such a contention it could be pointed out that an investment adviser is for some purposes a fiduciary, and that as a general rule a trustee (i.e., a fiduciary) must not rely on a third party to select investments (Restatement, Second, Trusts, § 171). I turn now to this argument.

The rule as set forth by § 171 of the Restatement of Trusts is as follows:

> "The trustee is under a duty to the beneficiary not to delegate to others the doing of acts which the

trustee can reasonably be required personally to perform."

This is amplified by Comment h, which states:

> "A trustee cannot properly delegate to another power to select investments."

The cases in which this rule has been invoked to hold a trustee liable have involved a virtually complete delegation of the trustee's powers and functions. For example, in *Meck* v. *Behrens*, 252 P.91 (Wash. 1927), the trustees had by contract turned over to a corporation the entire administration of the trust property, and In *re Shintaffer's Estate,* 4 P. 2d 764 (Kans. 1931) an executor had authorized another individual to make investments without any supervision by the executor.

I have found no case which holds that a trustee may not decide to make—or retain—an investment based upon the recommendation of a qualified professional, under circumstances such as those in which Anchor acted. On the contrary, in *In re Kohler's Estate*, 33 A.2d 920 (Pa. 1943), the court refused to surcharge an executrix who had entered into an agency agreement with a trust company which was to make such investments as she should authorize and was to suggest suitable investments. The court held that since the executrix maintained constant contact with the agent, knew of the transactions, and approved them there had been no improper delegation; it stated that if full power to manage and invest had been turned over, the executrix would have been liable for any loss. Compare *In re Estate of Quinlan*, 273 A.2d 340, 342 (Pa. 1971), where the court stated that the executor had "permitted the Bank to exercise on his behalf practically all of the duties and functions of an executor" and held that "this delegation is, of course, improper."

Accordingly, it is my opinion that there was no improper delegation by Anchor within the meaning of the above-described rule.

Moreover, if the "no delegation" rule is intended to apply to trustees a rigid test which goes beyond that of reasonableness and prudence under the circumstances, and to impose liability without regard to good faith and the reasonableness of the action actually taken, it is my belief that it should not be extended to apply to investment advisers, who certainly are not trustees in the strict sense.

It is true that some Courts have referred to an investment adviser as a "fiduciary", but this has been in the context of a holding that the adviser must, like a fiduciary, avoid conflicts of interest and must act in good faith (*Securities and Exchange Commission* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 191, 194 (1963)), or that the adviser may not profit from the sale of his office (*Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir., 1971)). This, of course, does not mean that an investment adviser is a fiduciary for *all* purposes, and I know of no case which so holds. Indeed, that the use of the term "fiduciary" is not dispositive is clearly indicated in *Rosenfeld* v. *Black, supra*, where the court said (445 F.2d at 1343):

> "While 'to say that a man is a fiduciary only begins analysis' . . . we would see no reason why the 'well-established principle of equity' forbidding realization of profit for effecting the turn-over of *corporate or other fiduciary office* should not apply to the investment adviser of a mutual fund." (emphasis supplied)

Since, then, I am of the view that reasonableness and prudence under the existing circumstances is the appropri-

ate test, and that any rule which goes beyond such a test and imposes liability without regard to good faith and the reasonableness of the action taken should not be extended beyond the areas to which existing authority applies it, I conclude that this aspect of the trustee rule should not be applied to investment advisers.

As already noted, however, the absence of authority could permit a court to take a contrary view, to apply the strict rule to investment advisers, and hold that Anchor's actions in purchasing the Penn Central paper were in contravention of the rule and accordingly subjected Anchor to liability for the Penn Central loss.

It would also be possible for a court to adopt a somewhat less stringent view and hold that since Anchor did not make its own investigation, it is bound by what such an investigation would have shown, so that the reasonableness and prudence of the purchase of Penn Central paper must be determined by a jury—or the court as the trier of fact—on the basis of the facts which would have been learned by the investigation. Obviously, one cannot predict what a jury, or a court, will find on the facts, particularly with the benefit of hindsight. In view, however, of the identity of other purchasers of the paper at that time (and indeed at much later dates), it is not a foregone conclusion that the finding would be that the Penn Central paper should not have been purchased.

Common Law Liability of Anchor for Retention

Since, in my opinion, Anchor is not liable because of the purchase of the Penn Central paper, it becomes necessary to consider those allegations of the complaint in the derivative action which charge that in the period subsequent to the purchase of the Penn Central paper Anchor

did not commence an adequate investigation of, and keep under continuous review, the financial condition of Penn Central; that such an investigation and review would have revealed certain material adverse facts; and that Anchor failed to advise the Fund of the advisability of attempting to resell the paper.

The questions which these allegations raise are: (1) did Anchor's failure, under the circumstances, to make an independent investigation of Penn Central's financial condition after the purchase, and to maintain a continuous review thereafter, violate the standard of good faith, reasonableness and prudence enunciated above? (2) If so, would a reasonable and prudent adviser have concluded that an attempt to resell the paper should be made? (3) If so, when would such a conclusion have been reached, and would it have been possible at that time to resell the paper and, if so, how much could have been resold (i.e., to what extent was any inaction by Anchor the cause of the loss)?

These questions arise only if (as I believe should be the case) Anchor is found not liable for the purchase, i.e., only if Anchor is found to have acted reasonably and prudently in purchasing the paper. In this context, it is my opinion that it did not breach any duty to the Fund in not conducting a subsequent investigation or review.

If the initial purchase did not give rise to liability on Anchor's part because Anchor acted reasonably and prudently in relying on the combination of factors already described—including the current credit analysis which it believed Goldman, Sachs had made and the short-term maturity of the paper—I believe it was equally reasonable and prudent for Anchor to rely on those same factors in retaining the paper. A "prime" rating by the National Credit Office and a recommendation based upon a current

analysis by Goldman, Sachs, which must have been made in the light of the maturity of the paper being offered, could have no meaning except that such short-term paper could safely be purchased *and held to maturity*. Furthermore, Goldman, Sachs was continuing to offer and sell substantial amounts of Penn Central paper during the first quarter of 1970, thus apparently indicating its own belief, presumably based upon continuing analysis, that such paper was safe.

Here, again, there is no available authority. It is, therefore, possible that a court could hold that, despite the absence of liability for the initial purchase, and particularly in view of the fact that the Penn Central paper had the maximum permissible maturity for commercial paper—namely 270 days—a reasonable and prudent investment adviser should have conducted its own review, or at least assured itself that Goldman, Sachs was in fact conducting a continuing review and found no cause for changing its favorable recommendation.

If a court were so to hold it would have to consider questions (2) and (3), above (p. 27). Likewise, if the court were to adopt the less stringent rule described above (p. 26), and hold that as a matter of law Anchor was required to make its own initial investigation and—although not automatically liable for failure to do so—is liable if such an investigation should have led it to refrain from making the purchase, the court could also determine that Anchor was required to conduct a continuing review and would have to consider the same two questions.

These questions would be questions of fact, to be decided by the trier of fact, be it court or jury. It is, of course, impossible for one to predict what such a trier of fact will find, particularly in complex circumstances. It must be noted,

however, that the complaint in the derivative action alleges [¶ 28(f)] that after April 22, 1970 it had become "virtually impossible for Goldman, Sachs to resell Penn Central commercial paper as it became due." Thus, although the period during which the complaint alleges that a review should have been continued was November 28, 1969 to June 21, 1970—the date of the reorganization petition—we are in fact dealing with a period ending no later than April 22, 1970, for it appears that whatever adverse information could have been ascertained thereafter could not have affected the result for the Fund.

The principal adverse information which investigation or review during this period would have disclosed seems clearly to be the substantial loss incurred for the first quarter of 1970, ended March 31, 1970. The report of this loss was released on April 21 but was not printed in the Wall Street Journal until April 23, 1970. Had Anchor determined at that time, because of the loss, to attempt to resell the Fund's Penn Central paper, it appears likely that it would not have been able to do so.

These circumstances, in my judgment, reduce the likelihood that the trier of fact will find that, had Anchor conducted its own review, it would have determined to resell the Penn Central paper at a time when this could have been done. Without such a finding, Anchor would not be liable for its failure to conduct a review.

Contractual Liability of Anchor

The Agreement for Investment Supervisory and Corporate Administrative Services between the Fund and Anchor, dated August 22, 1969, and in effect until May 1, 1970,

contains the following provisions relating to Anchor's obligations to furnish investment advice and supervision:

> "FIRST: Anchor shall supervise the investment operations of the Fund and the composition of its portfolio, and, to the extent reasonably required in the conduct of the business of the Fund, Anchor shall furnish to the Fund from time to time advice and recommendations with respect to investments, investment policies, the purchase and sale of securities and the management of its resources. In the performance of this function, Anchor shall also from time to time furnish to the Fund such reports and information relating to industries, businesses, securities, monetary and other economic factors and conditions, and such other information and advice, as may be reasonably required by the Fund or as Anchor may deem to be helpful to the Fund."
>
> "SECOND: * * *"
>
> "THIRD: Anchor agrees to use its best efforts in the furnishing of investment supervisory and corporate administrative services hereunder, and shall at all times maintain a staff of officers and other trained personnel for the purpose of performing its obligations under this agreement. Anchor may, at its expense, employ other persons to furnish administrative services to the Fund or to furnish to Anchor statistical and other factual information, advice regarding economic factors and trends, information with regard to technical and scientific developments, and such other information and assistance as Anchor may desire."

In my opinion nothing in these provisions imposes on Anchor the duty to make its own independent investigation of the financial condition of Penn Central prior to its purchase of the Penn Central paper or while the Fund held such paper. On the contrary, I believe they impose on Anchor the duty to act in good faith, with the degree of skill and knowledge normally possessed by investment advisers. That the test is one of reasonableness under the circumstances is attested by the phrase "reasonably required" used twice in paragraph FIRST. And of equal importance, paragraph THIRD explicitly authorizes Anchor to employ persons not on its own staff to furnish factual information, advice concerning economic factors and trends, "and such other information and assistance as Anchor may desire"; this provision seems clearly to permit Anchor to rely on such information and assistance if it was reasonably prudent in selecting the person who rendered it.

For these reasons and the additional reasons discussed in connection with Anchor's common-law liability, it is my opinion that the Agreement does not impose upon Anchor any liability for the Penn Central loss.

Common-law Liability of the Fund Directors

The Fund is a Delaware corporation, and the duties and liabilities of its directors are therefore governed by Delaware law. Under Delaware law, as stated in *Graham v. Allis-Chalmers Manufacturing Company,* 188 A.2d 125, 130 (Del. 1963),

> ". . . directors of a corporation in managing the corporate affairs are bound to use that amount of care which ordinarily careful and prudent men would use in similar circumstances. Their duties are those

of control, and whether or not by neglect they have made themselves liable for failure to exercise proper control depends on the circumstances and facts of the particular case.

* * *

". . . If he has *recklessly* reposed confidence in an obviously untrustworthy employee, has refused or neglected *cavalierly* to perform his duty as a director, or has ignored either *willfully* or through *inattention* obvious danger signs of employee wrongdoing, the law will cast the burden of liability upon him." (emphasis supplied)

The rule stated in the *Graham* case applies to the directors of both a mutual fund corporation and an ordinary Delaware corporation. See *Lutz* v. *Boas*, 171 A.2d 381, 395 (Del. Ch. 1961).

The Delaware rule is similar to the statutory rule in New York and New Jersey, where a director is required to act "in good faith and with that degree of diligence, care and skill which ordinarily prudent men would exercise under similar circumstances in like positions." N.Y. Business Corporation Law, § 717; N.J. Business Corporation Act, § 14A:6-14.

While in theory the investment adviser of a mutual fund merely makes recommendations to the fund, which, acting through its officers and under the supervision of its directors, makes the actual decisions, in practice it is abundantly clear that all decisions on the purchase and sale of specific securities are necessarily made by the adviser, whose employees serve also as the officers and employees of the fund, and that the Board of Directors of the fund is necessarily limited to the "control" function referred to in the *Graham* case, above, that is, the review of

and decisions on the basic investment policies, and general supervision of the procedures and performance of the adviser. This is substantially the same as the function of the Board of any ordinary business corporation, which could not and would not decide on the types of raw materials or machinery which the corporation purchases or the details of the design, production and marketing of its products, but rather is responsible for the selection, and review of the performance, of the management and for basic corporate policy. Clearly, under the rules stated above, a Board of Directors would not be held liable for losses caused by management actions taken in good faith and judged as reasonable under the circumstances. Similarly, the directors would not be held liable even for management actions which are subsequently viewed as negligent, provided the Board had no reason to suspect that management was not acting properly, and was not, and in the exercise of normal prudence could not be, aware in advance of the action to be taken.

Since it is my opinion that Anchor did not violate any duty to the Fund either in the purchase or in the retention of the Penn Central paper, it follows that the Fund directors violated no duty in connection therewith and, therefore, have no liability for the Penn Central loss.

Even if it were held that Anchor had a duty to make an independent investigation or review of Penn Central's financial condition, it is my opinion that under the principles of law applicable to directors, the Fund's directors would not be liable for the Penn Central loss. In the purchase of commercial paper for the Fund, Anchor had for about four years bought directly from the eight issuers on its approved list, and had commenced purchasing from dealers only shortly before the purchase of the Penn Cen-

tral paper. There is no evidence that the Fund directors knew before the Penn Central purchase either that (i) a change in procedure had been made and that some dealer paper was being purchased or (ii) that Anchor was not making an independent investigation of the companies whose paper was being bought from dealers; furthermore, there is no clear evidence that it knew thereafter. According to the minutes of a Board meeting held on December 17, 1969, the purchase of commercial paper was discussed, but the nature of the discussion is not indicated. Kesselhaut thinks that he explained that dealer paper was being purchased, and may have discussed the procedure for purchasing dealer paper, but he is not certain, and Haire had no recollection on the subject. Under these circumstances it is an issue for the trier of fact to ascertain whether the Board knew, or should have known, even some time after the Penn Central purchases, that dealer paper was being purchased without an investigation and analysis by Anchor.

Furthermore, even if the Fund directors did know or should have known, it is my opinion that they did not violate their duties as directors by not requiring Anchor to undertake an immediate investigation or to attempt to resell the Penn Central paper. Since I believe that Anchor itself acted reasonably and prudently in purchasing and holding the Penn Central paper in reliance on the factors discussed above, and since there is no existing authority indicating that Anchor was required to make its own investigation and analysis, I believe the Fund directors would clearly have been warranted in accepting this procedure and I do not believe they could be found to have been negligent in doing so.

Section 13(a)(3) of the Investment Company Act of 1940

Section 13(a)(3) of the Investment Company Act of 1940 in part prohibits an investment company from deviating, without shareholder approval, from any policy it has deemed to be fundamental in its registration statement.

I understand that the original registration statement filed by the Fund stated as a fundamental policy that it would not "purchase" more than 10% of the securities of any one issuer. I have been informed that the registration statement has been amended on numerous occasions and that the precise content of the registration statement during 1969-1970 is not readily determinable. The original source of the 10% limitation was apparently a by-law provision which has since been replaced by a provision in the Fund's certificate of incorporation stating that the Fund may not "acquire or hold more than ten percent (10%) of the outstanding securities of any one issuer". Since it is likely that the registration statement is no more permissive than the Fund's charter document, I think it appropriate to assume that fundamental policy prohibits the retention, as well as the acquisition, of more than 10% of an issuer's securities. This is consistent with the Fund's prospectus (as revised September 2, 1969). It is clear that the application of the restriction is not limited to voting securities.

In my opinion this fundamental policy did not prohibit Anchor from continuing to hold $20,000,000 of Penn Central commercial paper at a time when the total amount of outstanding Penn Central commercial paper fell below $200,000,000. The restriction is expressed in terms of the "securities" of the issuer, not in terms of any "class of securities."

The issue is simply whether $20,000,000 of commercial paper constituted more than 10% of Penn Central's "secu-

rities". I believe that it manifestly did not. Commercial paper accounted for only a small fraction of Penn Central's securities. As of December 31, 1969, Penn Central's balance sheet showed debt securities of over $1,793,000,000; even if secured debt is excluded, total short-term debt and unsecured bank borrowings were $500,000,000. These were, in my opinion, part of Penn Central's "securities," so that the Fund's holdings of commercial paper did not approach 10%.

Alternative Courses of Action

With the Fund's claim against Goldman, Sachs & Co. settled, the Fund must now determine the position which it will take in the *Lasker* derivative suit. In the present posture of that suit the Fund has three alternative courses of action:

1. As the party in whose interest the suit has been commenced, the Fund might seek realignment so as to become a plaintiff for the purpose of exercising control over and prosecuting the action.

2. The Fund might take the position that the action is sufficiently lacking in merit that it should not be prosecuted and should therefore be dismissed.

3. The Fund might take a neutral position, permitting the action to proceed for its benefit under the auspices of the present plaintiffs.

The first alternative would involve legal expense to the Fund, likely to be substantial, in pursuing a claim which, in my opinion expressed herein, should not be sustained.

Further, it would probably require the Fund to terminate its advisory agreement with Anchor, since it might have a prejudicial effect upon a court or jury if the Fund were vigorously prosecuting a suit against Anchor while at the same time retaining it as adviser.

If the second alternative were adopted and the Fund were actively to seek dismissal of the suit, current court procedures would appear to require a hearing substantially on the merits. The cost to the Fund of such a proceeding, in which it would be seeking to defeat a very large claim on its behalf brought by its stockholders, might be substantial. Furthermore, to the extent that the Fund directors who are defendants in this suit were to incur legal expenses for their own counsel in connection with the proceedings, the Fund might be liable to indemnify such directors for these expenses to the extent not covered by an indemnity policy.

If the third alternative were adopted and the suit permitted to proceed without active participation by the Fund, the Fund might again be liable to indemnify its directors for their legal costs, unless they were held liable to the Fund for the Penn Central loss. This alternative would leave to the court the final determination of the difficult questions of fact and law involved, while retaining the possibility of a substantial recovery for the Fund.

It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt.

Very truly yours,

s/ Stanley H. Fuld

Exhibit C to Affidavit of Leon T. Kendall sworn to January 23, 1975—Supplemental Report of Stanley H. Fuld to Board of Directors of Fundamental Investors, Inc. dated December 18, 1974

(Letterhead of)

STANLEY H. FULD
425 Park Avenue
New York, N.Y. 10022

December 18, 1974

PRIVILEGED AND CONFIDENTIAL
Board of Directors
of Fundamental Investors, Inc.
Westminster at Parker
Elizabeth, New Jersey

Dear Sirs:

This letter is intended to supplement my opinion, dated December 5, 1974.

First, I have been asked whether Goldman, Sachs & Co. agreed to repurchase all commercial paper which it sold to the Fund (including the Penn Central paper); if so, whether this was a legal and binding agreement and, if it was, why prompt legal action was not taken against Goldman, Sachs, based on the agreement.

As I pointed out in the opinion letter, Anchor required all issuers, from whom the Fund purchased commercial paper directly, to agree to repurchase it on demand, in order to provide liquidity—in order, in other words, to enable the Fund to convert paper into cash prior to maturity if the cash were unexpectedly needed. Clearly, a repurchase agreement *by the issuer* was not regarded as a guaranty, or safety factor, against bankruptcy of the issuer.

I believe that Mr. Haire's establishment of a repurchase agreement as a condition of the purchase of dealer paper had the same purpose, and he and Mr. Kesselhaut have, in

fact, stated that they looked upon it as a liquidity device rather than as a guaranty against loss. Indeed, it seems unlikely that they could have regarded the agreement as a guaranty against loss or as anything other than an undertaking to attempt to resell the paper to the issuer or others if the Fund so wished.

Accordingly, it appears clear that there was not—and that Anchor did not believe there was—any legal, binding agreement by Goldman, Sachs to repurchase the Penn Central paper. That being so, the Fund was warranted in not basing its suit against Goldman, Sachs upon such an agreement. I would merely add that, when Goldman, Sachs declined to repurchase the paper, it appears that Anchor sought unsuccessfully to have it repurchased by Penn Central, and that by then there had ceased to be any market for Penn Central paper.

Second, I have been asked to discuss more fully the rules relating to a possible position by the Fund's directors that prosecution of the derivative action is not in the Fund's best interests and that, consequently, the suit be dismissed.

The law is clear that the mere fact that a corporation has a supportable claim does not mean that the corporation must assert the claim in a lawsuit. As the Supreme Court (per Brandeis, J.) wrote in *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), whether the corporation should "seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors. . . ." See, also, *Swanson* v. *Traer,* 249 F.2d 854 (7th Cir. 1957); *Ash* v. *International Business Machines, Inc.*, 353 F.2d 491 (3rd Cir. 1965); 13 Fletcher, Cyc. Corp., § 5822, p. 131. The same rule should, presumably, apply to a determination by the directors that an action commenced on behalf of the corporation by a stockholder should not proceed.

The law is not clear, however, on the extent to which a court will review the determination of the directors in such a case.

Language in some of the decisions indicates that the court should be concerned solely with the honesty and good faith of the Board's determination. Thus, in the *Ash* case, 353 F.2d 491, supra, the Court of Appeals for the Third Circuit declared (at 493):

> "The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring anti-trust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way. [Cases cited.] Prevailing doctrine in the state courts is to the same effect.'

On the other hand, there are cases which suggest that more is required, that the directors must, as they are required to do generally, exercise ordinary prudence or diligence, that there must be some reasonable basis for the decision reached. For example, in *Levine* v. *Behn,* 174 Misc. 988 (Sup. Ct. N.Y. 1940), aff'd, 262 A.D. 729 (1941)—a case in which a derivative suit was brought against directors for paying rather than contesting a claim—the court wrote (174 Misc. at 991-2):

> "The test in each case, however, is the same, viz., whether or not the directors acted honestly and diligently and with a view to the promotion of the interests of the corporation. Of course, neither actual good faith nor advice of counsel will save directors if the facts afford no reasonable basis for a belief that a payment is for the best interests of the corporation. Honest belief without any basis in fact must be attributable to negligence."

And in *Perrine* v. *Pennroad Corporation,* 47 A. 2d 479 (Sup. Ct. Del. 1946)—a case involving the settlement of a lawsuit—the high court of Delaware declared (at 489):

> "Good faith may always be brought in question where it appears that the settlement of a dispute between stockholders of a corporation is so grossly inadequate that one is required to reach the decision that the directors were reckless and indifferent as to the rights of the stockholders and did not exercise reasonable business judgment."

In considering the subject before us, a word should be said of Rule 23.1 of the Federal Rules of Civil Procedure which provides, in part, that a derivative suit may not be "compromised" or "dismissed" without approval of the court. Although dismissal of the *Lasker* derivative action falls within the literal language of the Rule, it has been suggested that it does not apply to an involuntary dismissal. (Wright and Miller, 7A Federal Practice and Procedure, § 1839, p. 436.) However, since there are certain parallels between the two situations, I call your attention to the recent Second Circuit decision in *City of Detroit* v. *Grinnel Corporation,* 495 F.2d 448 (1974), which describes the court's role when approval of a settlement is sought (at 462):

> "When a District Court exercises its authority in approving a settlement offer, it must give compre-

hensive consideration to all relevant factors and yet the settlement hearing must not be turned into a trial or a rehearsal of the trial. [Case cited.] The Court must eschew any rubber stamp approval in favor of an independent evaluation, yet, at the same time, it must stop short of the detailed and thorough investigation that it would undertake if it were actually trying the case."

If it were to appear to the Fund's nonaffiliated directors that the Fund's interests would be adversely affected by allowing the *Lasker* suit to continue to trial and decision and that it would be in the Fund's best interests to forego any possible recovery and have the suit dismissed, the directors could, of course, take those matters into account. And, if the directors were to conclude that reasons were presented which were persuasive and sufficient, they could then decide to seek dismissal. If this were done, the scope of review would be determined by the court in the light of the rules discussed above.

In short, it is my view that, at a minimum, the court would review the reasons for seeking dismissal and might consider, at least to some degree, the underlying merits of the derivative action. Whether reasons can be adduced, with supporting facts, sufficient to persuade the nonaffiliated directors to seek dismissal, and sufficient to persuade the court that a proper basis exists for the directors' action, must await a presentation to the directors.

Very truly yours,

s/ Stanley H. Fuld

Exhibit D to Affidavit of Leon T. Kendall sworn to January 23, 1975—Minutes of meeting of Board of Directors of Fundamental Investors, Inc. dated December 18, 1974

FUNDAMENTAL INVESTORS, INC.

Minutes of Meeting of Board of Directors

December 18, 1974

A special meeting of the Board of Directors of Fundamental Investors, Inc. was held on December 18, 1974 at the office of the Fund, Westminster at Parker, Elizabeth, New Jersey. The special meeting convened at 2:30 p.m. There were present:

Leon T. Kendall
Louis F. Laun
Mary S. O'Connor
Beryl Robichaud
William J. Stephens

constituting a quorum of the Board of Directors of the Fund for the special meeting. Mr. Leon T. Kendall was appointed by the Board of Directors as Chairman of the special meeting. The Board agreed on the procedure to be followed at the special meeting.

The following persons were invited to join the meeting at 3:10 p.m. for the purpose of responding to questions of the five directors: Hon. Stanley H. Fuld, Special Counsel to the Fund, John R. Haire, Chairman and Chief Executive Officer of Anchor Corporation, Donald M. Kemmerer and Charles F. Phillips, directors of the Fund, and Eugene P. Souther, Esq., counsel to the Fund.

Mr. Kendall presided and Mr. Souther acted as Secretary of the meeting.

The special meeting was held to consider further the Fund's holding of commercial paper of Penn Central Trans-

portation Company ("Penn Central") and also what further action, if any, the Fund should take with respect to the action entitled *Lasker, et al.* v. *Harry G. Burks, Jr., et al.* in the United States District Court for the Southern District of New York allegedly brought on behalf of the Fund by two individual shareholders of the Fund against Anchor Corporation and those directors who were members of the Board of Directors of the Fund at the time of the purchase of the Penn Central commercial paper.

Mr. Kendall called upon Special Counsel, former Chief Judge Fuld, who reported on the status of the *Lasker* action, described the claims made in that action and expressed his opinion as to the merits of each of those claims. Judge Fuld then discussed the alternatives available to the Board and the standards it should apply in deciding what course of action to pursue, stressing that Messrs. Kendall, Laun, Stephens and Mrs. O'Connor and Dr. Robichaud should act independently of the remaining members of the Board in deciding what in their business judgment exercised in good faith was in the best interests of the Fund.

Judge Fuld advised that the Fund had three alternatives:

1. Seek to realign itself as a party plaintiff in the action and take control of the prosecution of the action;

2. Instruct its counsel to seek to dismiss the action on the grounds that it was not in the best interests of the Fund to pursue it; or

3. Remain neutral in the role of a nominal party defendant and allow the action to proceed as directed by the shareholders who instituted the action.

Judge Fuld then summarized the analysis of the facts and law and the opinions as to the merits of the causes of action alleged in the complaint that he had set forth for the Board in his letters to the Board of December 5, 1974 and December 18, 1974.

Because he had concluded that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, Judge Fuld advised against adopting the first alternative.

As to the second alternative, Judge Fuld counselled that the Board could conclude that there was no basis for the action and that its continuance would be damaging to the Fund. Such a decision would have to be made independently, in good faith and through the sound exercise of business judgment as to what action was in the best interest of the Fund. Should the Board conclude that it was not in the best interest of the Fund's shareholders or of the Fund for the action to continue, it could then instruct its counsel to move to dismiss the action.

The third alternative would leave the Fund in the role of a nominal party defendant taking no active part in the litigation but allowing the action to proceed against Anchor Corporation and the named directors of the Fund. In deciding whether to follow that course, Judge Fuld advised, among other things, that the Board could consider what effect the continued prosecution of the action could have on the Fund. There might result serious distraction of Anchor Corporation from its duties as adviser to the Fund caused by the preparation for and defense of the action. Anchor's ability to attract and retain qualified personnel under the circumstances might be affected. Any ultimate recovery might not be worth the serious impact

on the Fund of the prosecution of such an action to a conclusion.

The directors then questioned Judge Fuld at length concerning the facts and the law and his opinion as to the merits of the claims made and the chances of success on them. During that discussion Judge Fuld amplified on the contents of his letters to the Board.

The Chairman then called upon Mr. Souther, who discussed the practical implications of following each of the alternatives available to the Fund and the nature and extent of the proceedings each alternative would entail. Mr. Souther advised the Board that it could consider the possibility that as a result of retention by the Fund of a 73.75% interest in the notes under its settlement with Goldman, Sachs, the Fund might recover some additional amount in the reorganization of Penn Central. He also described the discovery proceedings and trial preparation that could be anticipated if the action were to continue and the type of work interruption that activity could entail, which might well have an adverse effect on the Fund's shareholders. Mr. Souther pointed out that there could be a substantial cost to the Fund for attorneys' fees for its counsel as well as for outside directors who were found not to be liable to the Fund. Finally, he told them that they could properly consider not only the chances of securing a substantial judgment against Anchor Corporation and possibly the director defendants, but also the practical possibility of collecting such a judgment. Mr. Souther reiterated that it was up to the five above-named members constituting the Board for the purpose of making this decision to act independently and in good faith and to exercise their sound business judgment in deciding which alternative to follow.

The Board then sought the views of Special Counsel and counsel as to whether the Fund's earlier decision to settle its case against Goldman, Sachs and the subsequent jury award for the full amount of their claim for plaintiffs in the *Welch* action against Goldman, Sachs compelled the Board to continue the *Lasker* action. Mr. Souther pointed out his understanding that the facts in the Fund's action against Goldman, Sachs and those in the *Welch* action were different in at least three significant respects: (1) plaintiffs in the *Welch* action had purchased the commercial paper sometime after the Fund's purchases, at a time when Goldman, Sachs knew even more about the serious financial condition of Penn Central; (2) the Fund might have been held to a higher standard of inquiry than plaintiffs in the *Welch* action on the theory that it was a sophisticated investor; and (3) amount of the Fund's claim against Goldman, Sachs ($20,000,000 plus interest) was so large that a jury might be reluctant to award such a judgment against Goldman, Sachs whereas the claim of the three plaintiffs together in the *Welch* action was only for $3,000,000 plus interest.

The Board then addressed a substantial number of questions to Mr. Haire concerning the procedure followed by Anchor Corporation in 1969 in purchasing commercial paper in general and of Penn Central in particular. In response to the questions of the Board, Mr. Haire discussed, among other things, his belief that at the time of purchase Goldman, Sachs had agreed to repurchase the paper at any time; that in the course of the action against Goldman, Sachs the Fund had learned that during the period from February 1, 1968 through June 21, 1970 Goldman, Sachs had repurchased commercial paper of various issuers some 1200 times, including approximately 40 re-

purchases of commercial paper of Penn Central up to May 1, 1970, and had repurchased from the Fund commercial paper of Chrysler Corporation and other issuers; that Anchor had established guidelines for the purchase of commercial paper as follows:

(a) that it be rated "prime" by the National Credit office;

(b) that not more than 10% of the outstanding commercial paper of any issuer should be purchased; and

(c) that the dealer should agree to repurchase the paper at the Fund's request.

Moreover, Goldman, Sachs had assured the Fund that it had made a thorough credit investigation of Penn Central.

It was not until the filing of the petition for reorganization by Penn Central that Goldman, Sachs asserted that it was not legally obligated to repurchase the commercial paper. Mr. Haire stated his belief that the guidelines had been followed in making the purchase and explained that he and those who had participated in the purchase had assumed, based on his understanding of the general practice, that Goldman, Sachs had an agreement with Penn Central which in turn had an agreement with its bankers that would insure that the paper would be bought back promptly at the request of the Fund.

The Board then inquired into the extent of the information made available to the Board at the time of the purchase of the Penn Central commercial paper. Mr. Phillips and Mr. Kemmerer participated in that discussion along with Mr. Haire. Mr. Haire explained that due to the short-term nature of commercial paper investments the specific

purchases were not identified in the monthly reports made to the Board, but instead all short-term investments were combined and identified as such. Information as to specific holdings at any time was available from the treasurer. In addition, a presentation with respect to commercial paper had been made to the Board on December 17, 1969.

Mr. Haire explained that it had been considered sufficiently prudent to include commercial paper under the description "short-term investments" because at that time commercial paper was considered to be the equivalent of cash (Judge Fuld read from the report of the staff of the Securities and Exchange Commission following its investigation of Penn Central which observed that the financial community at that time considered commercial paper to be the equivalent of cash) and because the investment in commercial paper normally was of such a short duration that it would not be picked up in a monthly report. Mr. Haire pointed out that the financial community at the time considered Penn Central—a company with assets of $7 billion —to be a sound investment as is shown by the number of sophisticated investors who purchased its commercial paper after the Fund's purchases. In response to questions, Mr. Haire stated that he believed that Anchor Corporation had followed procedures which were prudent in light of the prevailing view of the safety of commercial paper in general and of the soundness of the investment in Penn Central and that to his knowledge the normal procedure followed by other mutual funds was to lump short-term investments and not to identify them specifically in published reports.

The directors asked for an identification of those who had purchased Penn Central paper subsequent to the purchases by the Fund and those who still held that paper at the

time the reorganization petition was filed. Mr. Haire undertook to try to supply such information to the Board as soon as possible and gave the Board an interim list of the banks that had purchased Penn Central commercial paper after the Fund's purchases and a list, which he could not assure was complete, of the holders of Penn Central commercial paper as of June 21, 1970, the day the reorganization petition was filed. Copies of those lists were annexed to the minutes of this meeting.

In response to questions, Mr. Haire reported that it was not unusual in 1969 for mutual funds to invest in commercial paper and that the Penn Central investment had been attractive to the Fund's advisers in the fall of 1969 because of an anticipated fall off in interest rates, which did occur, which made it appear advantageous to secure an investment paying an interest rate as high as 9%.

In response to questions, Mr. Haire reported that on learning in the latter part of May of an article in *Barron's* expressing some concern about the safety of commercial paper, the Fund had asked Goldman, Sachs to repurchase $10 million of the commercial paper. Goldman, Sachs did not refuse, but, in effect, put off the repurchase with the assurance that it was processing the request. Thereafter, Goldman, Sachs suggested that the Fund ask Penn Central to repurchase the commercial paper. Again, instead of outright refusal the Fund was met with what in effect was a delaying tactic. Goldman, Sachs finally refused to repurchase the Penn Central commercial paper.

The Board then discussed the standard to be applied to Anchor Corporation in determining the degree of care it should have exercised. Judge Fuld referred to the discussion of that subject contained in his letter of December 5 and expressed his opinion that even if Anchor Corporation

were to be held to a higher standard as a sophisticated investor, he believed that it met that standard by establishing and following its guidelines. Mr. Haire added that in addition to relying on Goldman, Sachs, those charged with making investment decisions had considered the purchase, they knew Penn Central since it was a recent equity holding of the Fund, and they raised no objection to the purchase of the Penn Central commercial paper.

Mr. Kemmerer and Mr. Phillips were excused from the meeting at this point.

The Board then discussed the question of the impact on Anchor Corporation and on the Fund's shareholders of the *Lasker* action being pursued either by the Fund or by the shareholders who brought the action. The price paid for the notes was slightly more than $18.5 million. Considering the cash settlement received from Goldman, Sachs and ignoring any possible recovery on the Fund's remaining 73.75% interest in notes, a judgment, if obtained, could possibly amount to $15 million. There being approximately 100 million Fund shares outstanding, if there were a recovery of a judgment of $15 million it could result in a recovery of no more than 15¢ per share; however, the extent of such recovery would be diminished by the fees payable out of that recovery to attorneys for plaintiffs in the *Lasker* action, fees for counsel for the Fund and, possibly, fees for counsel for Fund directors found not to be liable to the Fund. It was estimated that the attorneys for plaintiffs in the *Lasker* action, if successful, might ask the court to award them fees ranging from 15-30% of the judgment.

Concerning conduct of the action should it continue, Mr. Haire explained that regardless of the lack of merit of the action and of his belief that there was slight chance of success by plaintiffs, Anchor would, of course, be required to

defend the action to the fullest, which would necessarily present substantial distraction to Anchor. In addition, he questioned the ability of Anchor to attract and retain the highly qualified personnel they want and need if such an action were being pursued with the acquiescence, if not under the control, of the Fund.

The Board then considered the question whether, if there were a judgment for the full amount, it could be collected. Mr. Haire reported that Anchor Corporation's current net worth is approximately $12 million, a sum less than the amount of a possible judgment. Washington National Corporation, of which Anchor Corporation is a wholly-owned subsidiary, is not a party to the action and Mr. Haire cou'd not represent to the Board whether Washington National Corporation would assist Anchor Corporation in making up any differential should a judgment be entered larger than Anchor Corporation was able at that time to pay. In response to a question, Mr. Haire reported that Anchor Corporation's gross management fees in 1974 were expected to be $4.1 million and were estimated to be $3.8 million in 1975.

Mr. Haire was then excused from the meeting.

The Board then conducted further discussion with Special Counsel and reviewed the subjects which had been discussed earlier. Judge Fuld reiterated the criteria to be followed by the Board in reaching its conclusion and advised that in assessing the decision to be taken by the Board a court would consider its independence, its honesty and its good faith in reaching whatever business judgment it reached.

The Chairman then excused Special Counsel and counsel who left the meeting and the Board continued its discussions.

The Board members in executive session expressed a desire to review again the various documents pertaining to the situation and agreed to communicate to the Chairman any further questions or points of information desired. It was agreed that the Chairman would contact each member individually as to the next step for the committee to take.

The Board adjourned at approximately 6:00 p.m.

s/ Eugene P. Souther
Secretary

s/ Leon T. Kendall
Chairman

ATTACHMENTS TO MINUTES OF DECEMBER 18, 1974

BANKS

Manufacturers Hanover Trust
First National Bank
State Street Bank and Trust
National Bank of Wyandotte
National Sawmut Bank
Mellon National Bank and Trust Co.
Chemical Bank
Fairfield National Bank
Central National Bank and Trust
Security National Bank
Bank of Lyons
First National Bank of Tulsa
Fort Wayne National Bank
Bankers Trust Co.
City National Bank
Citizens Bank
Brown Bros. Harriman & Co.
Seattle First National Bank
First National Bank of Atlanta
Provident National Bank
Peoples Bank and Trust Co.
Security Pacific National Bank
First National Bank of Boston
Fort Worth National
Valley Bank and Trust Co.
Amoskeag National Bank
First National Bank of Elkhart
Northern Trust Co. of Chicago
First National Bank of Chicago
First and Merchants National Bank
National Boulevard Bank
Louisiana Bank and Trust Co.
The Fidelity Bank
Detroit Bank and Trust Co.
Marine Midland Grace Trust Co.
Worcester County National Bank
Wells Fargo Bank
First National Bank of Orlando
State National Bank
Philadelphia National Bank
Des Plaines Trust & Savings Bank of Chicago
United California Bank
Calumet National Bank
Webster Groves Trust Co.
First Security National Bank and Trust
Third National Bank of Hampden
First Wisconsin National Bank
American National Bank and Trust
National Bank of North America
Wachovia Bank and Trust Co.
Equitable Trust Co.
U. S. Trust Company
Bank of New York
Farmers Savings Bank
City Bank and Trust Co.
Old National Bank
North Carolina National Bank
First National Bank of Arizona
National Bank of Commerce
Union Bank
Garfield Ridge Trust & Savings Bank
Essex City Bank and Trust
Merchants National Bank
Palmer-American National Bank
Cleveland Trust Co.
Union Planters National Bank
Trade Bank and Trust Co.
Valley National Bank
Franklin Savings Bank
Chittenden Trust Co.
First National Bank of Passaic
Marshall & Isley Bank
Commercial National Bank

HOLDERS OF PENN CENTRAL COMMERCIAL PAPER AS OF JUNE 21, 1970

1. Archdiocese of Tucson (through Valley Bank)
2. United Conference of Catholic Bishops (through First National Bank of Chicago)
3. Pratt Institute (through Auchincloss & Lawrence and U. S. Trust Co.)
4. Good Hope Corporation (through Auchincloss & Lawrence and U. S. Trust Co.)
5. American Express Company
6. American Automobile Insurance Company
7. Getty Oil Company
8. Olympia Brewing Corporation
9. Welch Foods, Inc.
10. C. R. Anthony Co.
11. Younker Bros.
12. University of Southern California (through United California Bank)
13. L. E. Dixon Co. (through United California Bank)
14. Society for Ruptured and Crippled (through U. S. Trust Co.)
15. Greenwood Mills (through Mfrs. Hanover Bank & Trust Co.)
16. Glen Oaks Club (through Trade Bank)
17. A. C. Monk & Co.

Attachments to Minutes of December 18, 1974

18. Carnegie-Mellon University
19. University of Kentucky
20. Muhlenberg College
21. University-Hill Foundation
    Mallinckrodt Co.
    Niagara Permanent Savings & Loan
    College Life Insurance Company of Indiana
    Homestake Mining Co.
    Granite City Steel
    Norton Simon Corp.
    U. S. Steel Pension Fund
    Marshall & Isley Bank
    Royal Bank of Canada
    Ames Brothers
    Prentice-Hall & Subsidiaries Profit-Sharing Plan
    W. R. Grace & Co.
    Hawaiian Cement
    First Bank of Brownsville, Texas

Exhibit E to Affidavit of Leon T. Kendall sworn to January 23, 1975—Letter from William J. Stephens to Leon T. Kendall, dated December 31, 1974

(Letterhead of)

WILLIAM J. STEPHENS
21 Live Oak Road
Hilton Head Island, South Carolina 29928

December 31, 1974

Re: The Derivative Action
Lasker et al
February 1973

Dear Leon,

At this date I wish to advise that my tentative conclusion is that, in the best overall interest of Fundamental Investors, Inc., this derivative action should not be prosecuted and should therefore be dismissed.

I have given consideration to the following:

#1—Judge Stanley H. Fuld's statement contained in his letter of December 5, 1974 which reads—"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

#2—There is no hard evidence that the adviser did not exercise due care and diligence in the Penn Central transaction. The certain guidelines established for the purchase of commercial paper from dealers are evidence that this transaction was not entered into lightly. It is reasonable to conclude the guidelines were truly a sufficient safeguard.

#3—It is also reasonable for the adviser to place reliance on the presentation and recommendation of Goldman, Sachs & Co., a most astute, prestigious and highly regarded investment banker.

#4—As a purchaser, Anchor was in "first class" company and this conclusion was arrived at by an examination of the "Investor Sales Analysis" from 3/1/68 to 4/2/70, a 12 page document prepared by Goldman, Sachs & Co. Also examined was the list of 73 banks that bought and/or sold Penn Central paper, mostly for the account of customers. It seems evident that the investment community highly regarded the Penn Central commercial paper and purchased it as late as 4/2/70. The statement showed sales of $172,505,000 in this period, not including the $20,000,000 purchased by Anchor. The amount not paid at maturity was $52,205,000 including the $20,000,000 Anchor buy.

#5—Commercial Paper was fully accepted by the investment community. The outstanding commercial paper in the first part of 1970 exceeded $40 billion.

#6—In August 1968 the Interstate Commerce Commission gave Penn Central authority to sell $35 million in commercial paper. On December 17, 1968 the I.C.C. increased the authorization to $100 million. On May 18, 1969 Penn Central announced an increase to $150 million, approved by the I.C.C. On October 29, 1969 the I.C.C. agreed to permit the sale of up to $200 million. At this time the comment on the decision by the I.C.C. to increase to $200 million was, "On the whole, applicant is in a strong financial condition."

#7—Penn Central had a $50 million revolving credit plan. In April 1969, with First National City as the lead bank, the amount of the revolving credit was increased to $300 million. All $300 million was used by the railroad, which eventually defaulted on the loan. There were about ninety banks involved; the majors were First National City $35 million, Irving Trust and Morgan Guaranty $25 million each, Manufacturers Hanover $20 million, with Bankers Trust of New York, Chemical Bank New York Trust, First National Bank of Chicago and Continental Illinois Bank at $15 million each. It is clear the banks did not contemplate that the railroad would be bankrupt within 14 months!

#8—Of more than passing interest is the interlocks of Penn Central directors with the major banks of Penn Central and the railroads indebtedness to these banks as of May 12, 1970.

Director	*Bank*	*Amount*
S. Saunders	Chase Manhattan	$ 7,832,500
	First Pennsylvania	18,004,766
D. Beran	Provident National	57,074,895
P. Gorman	Bankers Trust	26,063,106
J. T. Dorrance, Jr.	Morgan Guaranty	90,972,957
A. E. Perlman ...	Marine Midland	1,083,651
R. S. Rauch, Jr. ..	Girard Trust	49,408,188
R. G. Rincliffe ...	Philadelphia National	12,480,000
	Total	$262,920,063

On June 8, 1970 International Utilities was the largest shareholder of Penn Central with 500,000 shares. They were in the midst of taking a loss of $8 million on their holdings. John Seabrook was Chairman of International Utilities and a Director of Penn Central.

Also it is to be noted that the total railroad indebtedness to First National City was more than $300 million. They were not represented on the Board of Penn Central.

My only comment on this is the observation that the Directors did not know or understand the "soft under belly" of the railroad until it was too late. Question?—If the Directors did not grasp the real financial posture of Penn Central, was it possible for Anchor to reach behind the scenes and get the true picture?

#9—On merger day February 1, 1968 Penn Central had assets of $6.5/7.0 billion. In just 871 days later, on June 21, 1970, bankruptcy proceedings were filed under Section 77. Penn Central was regarded as the backbone of the country's transportation system and had a "Rock of Gibraltar" stature. "Nothing can happen to Penn Central" was accepted in financial centers across the nation. "The banks are behind Penn Central," was regarded as Gospel.

#10—In part, my conclusion that the Lasker derivative action should not be prosecuted stems from my concern about the possible impact on *Anchor and Fundamental Investors, Inc.*

First, as to Anchor:

The amount involved exceeds the total assets of Anchor and, if the award was made, Anchor would cease to be a viable organization. Their ability to attract and retain skilled fund managers would be gone. It would indicate that the Fund Board believed Anchor had violated the law and breached their contractual obligations to the Fund. I do

not so believe. It would be inconsistent to retain Anchor as the Fund adviser and join in a suit against them at the same time. Would the Fund flounder in the interim of changing advisers? I fear so.

Second, as to the Fund:

The impact on the Fund, as a result of public knowledge that the Board had become a plaintiff in prosecuting Anchor would probably result in heavy redemptions. This would compel distress selling of the Portfolio in the current depressed market. As of November 30, 1974, Total Net Assets were $531 million, Short Term investments $21 million, Cash and Receivables $15 million. Net Asset Value per share was $5.13. Recovery of the total amount represents about $.13 a share which is 2½%. The Net Asset Value of the shares, I believe, would be damaged by a far greater percentage if the Board supported the suit. I do not make light of the sum involved but wanted to put it into perspective.

#11—It is my tentative business judgment that the Lasker suit is without merit and that it would not prevail.

Summary

These are my thoughts at this time. I will await answers to some questions that other Directors and I have asked before coming to a final conclusion.

Stephens Letter

Respectfully submitted,

s/ William J. Stephens

wjs/hl

Mr. Leon T. Kendall
7125 N. Barnett Lane
Fox Point
Wisconsin 53217

Mr. Leon T. Kendall
Mortgage Guaranty Ins. Co.
MGIC Plaza
Milwaukee, Wisconsin 53201

Mr. Louis F. Laun
Mrs. Mary S. O'Connor
Dr. Beryl Robichaud

Exhibit F to Affidavit of Leon T. Kendall sworn to January 23, 1975—Minutes of meeting of the Board of Directors of Fundamental Investors, Inc. dated January 6, 1975.

FUNDAMENTAL INVESTORS, INC.

MINUTES OF MEETING OF BOARD OF DIRECTORS
January 6, 1975

A special meeting of the Board of Directors of Fundamental Investors, Inc. was held on January 6, 1975 at the New York Yacht Club, 37 West 44th Street, New York, New York. After discussion commencing at 6:00 p.m., the special meeting convened at 7:30 p.m. There were present:

Leon T. Kendall
Louis F. Laun
Beryl Robichaud
William J. Stephens

constituting a quorum of the Board of Directors. In accordance with the decision reached at the special meeting held December 18, 1974, Mr. Kendall served as Chairman. Also present at the request of the Board of Directors to act as Secretary of the meeting was Eugene P. Souther, Esq., counsel to the Fund.

The special meeting was held to consider further the subjects discussed at the special meeting of December 18, 1974, and to decide what action the Fund should take with respect to the *Lasker* action.

The directors first reviewed and approved the minutes of the December 18, 1974 special meeting. The directors confirmed that none of them had been in contact with anyone affiliated with Anchor Corporation since the December 18, 1974 special meeting.

Mr. Kendall reported to the Board that Mary S. O'Connor was out of the country, but that he had discussed with

her at length the subjects to be convened at the meeting, knew her position on these subjects and had her instructions as to how to cast her vote.

Mr. Kendall reported to the Board that since the December 18, 1974 special meeting he had spoken with each of the other four designated directors concerning the position the Fund should take with respect to the *Lasker* action, and had received from them the additional questions they had on the matter. He reported that he had relayed those questions to special counsel and counsel, and that he had personally spoken with Judge Fuld about the alternatives available to the Fund, and also about the nature and extent of the hearing that might be conducted if the Board of Directors decided to direct counsel to move to dismiss the action.

In response to certain of the questions Mr. Kendall had relayed to counsel from members of the Board, Mr. Souther supplied (1) a detailed biographical sketch of the background and qualifications of Judge Fuld to supplement the information the Board had previously been given, (2) a memorandum outlining the necessary procedures and possible problems which might arise if the Board decided to terminate the advisory agreement between the Fund and Anchor Corporation, and (3) documents with respect to the guidelines now followed by Anchor Corporation concerning short-term investments, including commercial paper. Mr. Souther also reported: that Judge Fuld had never had any prior business connection with Anchor Corporation or anyone affiliated with it; that a computer print-out produced by Goldman, Sachs in the *Welch* action confirmed the identity of other institutional investors that had purchased six to nine month commercial paper of Penn Central; and that the approximate date of the failure of Mill Factors to repurchase commercial paper it had issued was in the spring of 1969.

The Board again reviewed the circumstances of the purchase of the Penn Central commercial paper by the Fund and the repeated and unsuccessful efforts made by the officers of the Fund to have Goldman, Sachs, and thereafter Penn Central, repurchase the commercial paper.

Mr. Kendall reported on his conversation with Judge Fuld covering the probable legal procedures and costs to the Fund directors and shareholders. He also reiterated Judge Fuld's thinking on the various alternatives.

The Board of Directors then discussed each of the three alternatives available. As to the first alternative, *i.e.*, that the Fund seek to realign itself as party plaintiff in the *Lasker* action for the purpose of exercising control over and prosecuting the action, the Board of Directors discussed, among other things, that to do so they would have to (1) determine that they disagreed with Judge Fuld's considered opinion that the directors should not adopt the first alternative because of the lack of merit to the action, (2) conclude that Anchor Corporation and the defendant directors, unaffiliated and affiliated, had violated the law and that Anchor Corporation had breached its contract with the Fund, and (3) decide that the prosecution of the action was in the best interests of the present shareholders of the Fund. The Board expressed its belief that pursuit of the first alternative would necessarily cause the Fund to seek to obtain a different investment adviser immediately, with inevitable serious disruption and damage to the shareholders of the Fund. The Board then considered the potentially disastrous effect on the Fund shareholders such a decision might have and compared it to the remote chance of collecting what would amount at most to between 10¢ and 13¢ per share (prior to counsel fees and expenses) or about 2% of the net asset value of the Fund.

The Board of Directors then agreed unanimously that the Fund should not pursue the first alternative set forth in Judge Fuld's December 5, 1974 memorandum, with Mr. Kendall reporting that Mrs. O'Connor was also against pursuing this alternative.

Concerning the third alternative set forth, *i.e.*, the possibility of taking no position and permitting the action to proceed under the control of the two present plaintiff shareholders, the Board of Directors discussed (1) the distraction and business interruption to Anchor adopting that alternative would present and the possible serious consequences to the shareholders of the Fund that could be expected to follow, (2) Judge Fuld's opinion that Anchor and the defendant directors had not violated the law and were not liable to the Fund, (3) the serious risk of injury to the shareholders from allowing the action to continue weighed against the small percentage per share net recovery which could be expected if there were a judgment in favor of the Fund, and (4) the possibility that the Fund might incur substantial attorneys' fees were the *Lasker* action to continue.

Mr. Kendall and the other directors then discussed in detail Mr. Stephens' letter to him and the other three directors, dated December 31, 1974, in which Mr. Stephens tentatively concluded, on the basis of the 11 detailed considerations he set forth, that the Fund should seek to dismiss the *Lasker* action because of his belief and business judgment that its prosecution was not in the best interests of the shareholders of the Fund. The discussion also covered a broad range of subjects centered on the anticipated effect on the shareholders of the Fund and the Fund if the action were to continue. The directors were concerned, among other things, that there might be immediate and

sizeable redemptions of Fund shares, distraction of the adviser from its duties, loss of employees and inability to attract new ones, loss of interest in the Fund by brokers and dealers, a question as to the continuing ability to sell shares of the Fund and possible eventual loss of the distribution network for shares of the Fund.

Mr. Kendall then reported to the directors on his lengthy discussion with Mrs. O'Connor on December 22, 1974. She had thoroughly reviewed Judge Fuld's memoranda of December 5 and December 18, 1974, Mr. Stephens' letter of December 11, and other material. Mrs. O'Connor had concluded that, for the reasons discussed by the other directors, as set forth above, the Fund should pursue the second alternative in Judge Fuld's December 5 memorandum and should seek to dismiss the *Lasker* action because it is not in the interests of the shareholders or the Fund that the action proceed.

On motion of Mr. Laun, seconded by Dr. Robichaud, the Board of Directors then unanimously adopted the following resolution:

> Resolved, that the law firm of Seward & Kissel, counsel to the Fund, be directed to take the action necessary to have the complaint dismissed in the action in the United States District Court for the Southern District of New York, entitled *Howard M. Lasker, et al.* v. *Harry G. Burks, Jr., et al.*

The Board adjourned at approximately 10:15 p.m.

s/ Eugene P. Souther
Secretary

Supplemental Affidavit of Roger T. Wickers, Sworn to May 4, 1975 in Support of Motion to Dismiss

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
73 Civ. 552 (HFW)

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

STATE OF NEW YORK } ss.:
COUNTY OF NEW YORK }

ROGER T. WICKERS, being duly sworn, deposes and says:

I submit this Supplemental Affidavit to verify certain facts set forth in the Reply Memorandum.

I have read the Reply Memorandum and, to the best of my knowledge all facts stated therein are true and correct. I expressly reaffirm, since it raises new factual matter, the description of the method of selection of the five disinterested directors contained in the second full paragraph on page 13 and the first full paragraph on page 14 of the Reply Memorandum.

I also expressly reaffirm that section 4 of Article VI of the By-Laws of Fundamental is as set forth on page 11 of the Reply Memorandum.

s/ ROGER T. WICKERS

Sworn to before me this
7th day of May 1975.

Excerpts from Defendants' Reply Memorandum

[From p. 11]

Section 4 of ARTICLE VI of the By-Laws of Fundamental provides that:

> "*Quorum:* Except as otherwise provided by law, the Certificate of Incorporation, or these By-Laws, at all meetings of the Board of Directors one-third of the directors then in office, but not less than three directors, shall be necessary for the transaction of business."

* * *

[From pp. 13-14]

Furthermore, plaintiffs erroneously argue that "Anchor controls the selection and nomination of the Fund's board of directors including the so-called independents" (Memorandum in Opposition, p. 41)—this is simply false and uninformed.

The nominees for directorships are searched for and recommended by the Directors' Qualifications Committee, an independent committee of the Board of Directors consisting of two outside directors not affiliated with Anchor and the President of the Funds who is affiliated with Anchor. Majority vote governs recommendation of nominees and, accordingly, it simply is not true, as plaintiffs assert, that "Anchor controls the selection and nomination of the Fund's board of directors including the so-called independents."

Each of the five disinterested directors who made the decision to terminate this litigation was originally selected by the Directors' Qualifications Committee. The five come from widely different backgrounds, and have, in common, excellence in their respective fields of endeavor. None of the five had any prior connection with Anchor.

PAPERS ON RENEWED MOTION TO DISMISS

Affidavit of Roger T. Wickers, Sworn to July 23, 1976 in Support of Renewed Motion to Dismiss

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK
73 Civ. 552 (HFW)

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

STATE OF NEW YORK } ss.:
COUNTY OF NEW YORK }

ROGER T. WICKERS, being duly sworn, deposes and says:

1. I am Senior Vice President of Fundamental Investors, Inc. ("Fundamental"), and I submit this affidavit in support of the renewed motion by Fundamental to dismiss this action.

2. Permission of the Court to renew the motion to dismiss was expressly granted in the Memorandum Decision and Order dated September 24, 1975, as amended October 17, 1975, and reported at 404 F. Supp. 1172 (S.D.N.Y. 1975) (Werker, J.). For the convenience of the Court, a copy of the Memorandum Decision and Order is annexed hereto as Exhibit A.*

* To avoid unnecessary repetition, I respectfully seek leave of this Court to incorporate herein by reference the moving papers and reply papers of defendants on the original motion to dismiss. Those papers are part of the file of this action, and, if desired, an additional set will be made available to the Court.

Affidavit of Wickers in Support of Renewed Motion to Dismiss

PRIOR PROCEEDINGS

3. Fundamental, joined by all other defendants, moved to dismiss this action on the grounds that it was not in the best interests of the shareholders of Fundamental. The motion was made pursuant to a determination by a quorum of disinterested directors in the exercise of their business judgment, after receiving the advice of independent special counsel. Plaintiffs opposed the motion on numerous grounds. This Court, in the Memorandum Decision and Order, considered and rejected each and every argument advanced by plaintiffs in opposition to the motion by defendants to dismiss.

4. The sole issue that was left open by this Court in the Memorandum Decision and Order is: were the five members of the Board of Directors of Fundamental who made the decision to move to dismiss this action disinterested and independent, or were they, as plaintiffs contend, interested and lacking independence. This Court wrote (404 F. Supp. at p. 1180):

> "If the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board."

5. This Court then permitted plaintiffs "to pursue discovery with respect to the relationships of the minority directors and the Qualification Committee to determine whether the minority directors were disinterested or independent." 404 F. Supp. at p. 1180. The discovery has now been completed and the results are described hereinbelow.

Affidavit of Wickers in Support of Renewed Motion to Dismiss

THE DISCOVERY PROCEEDINGS

6. Plaintiffs conducted the depositions of each and every one of the five members of the Disinterested Quorum, as well as the deposition of the Chairman of Anchor Corporation ("Anchor"), the investment adviser to Fundamental. The testimony exceeds 1,000 pages of transcript. In addition, defendants made two major document productions, satisfying all requests made by plaintiffs for production of documents.

7. Despite extensive discovery proceedings, the plaintiffs have failed to turn up any evidence whatsoever that any of the five directors who made the decision for the Board (Messrs. Kendall, Stephens and Laun, Dr. Robichaud and Mrs. O'Connor) was not truly disinterested and independent.

8. Each of the five directors submitted himself or herself to extensive, probing questioning on their business and personal relationships with all of the named defendants. The testimony is abundantly clear that none of these five persons—each a highly distinguished individual in his or her own career—was interested or lacking independence. Each made his or her own decision independently, thoughtfully and with the advice and assistance of eminent special counsel, Stanley H. Fuld, former Chief Judge of the State of New York.

PERTINENT TESTIMONY

10. Dr. Beryl Robichaud, a Senior Vice President of McGraw Hill, Inc., testified that she had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 120-2);* that no one

* References in parentheses are to pages of the deposition transcripts.

from Anchor attempted to influence her deliberations as a member of the Disinterested Quorum (p. 123); and that she made her decision in this case solely on the basis of what she believed to be in the best interests of the shareholders (pp. 124-5). Copies of the foregoing pages of testimony of Dr. Robichaud are annexed hereto as Exhibit B.

11. Mrs. Mary S. O'Connor, a director and member of the Executive and Trust Committees of the Central Home Trust Company, Elizabeth, New Jersey, and one of the first female officers of IBM, testified that she had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 83-6); that no one from Anchor or any of the defendants attempted to influence her deliberations as a member of the Disinterested Quorum (p. 86); and that she felt under no pressure whatsoever from anyone at Anchor in connection with making her decision (p. 87). Copies of the foregoing pages of testimony of Mrs. O'Connor are annexed hereto as Exhibit C.

12. Leon T. Kendall, President of Mortgage Guaranty Insurance Corporation, Milwaukee, Wisconsin, testified that he had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 217-23); that he had never had any economic relationship of any kind with Mr. Haire (p. 224); that Mr. Haire never attempted to influence his deliberations as a member of the Disinterested Quorum (p. 225); and that he felt under no pressure whatsoever from Mr. Haire with respect to his deliberations as a member of the Disinterested Quorum (p. 225). The sole prior connection that Mr. Kendall had with Anchor Corporation was remote and immaterial; Anchor Corporation had been one of approxi-

mately 600 members of a trade association called the Investment Bankers Association which was merged into another association called the Securities Industry Association, of which Mr. Kendall was President (pp. 217-23). Mr. Kendall, in summing up the situation, testified as follows:

> Q. Can you tell us once again, in your own words, the extent of your business relationship or professional relationship, if any, with Mr. Haire prior to the time that you became a director of Fundamental Investors?" A. I had no business, professional, economic, financial relationships with Mr. Haire. The only relationship that existed was in the Trade Association, which I headed, and of which his company was a member." (p. 226, see also 11-22).

Copies of the foregoing pages of testimony of Mr. Kendall are annexed hereto as Exhibit D.

13. William J. Stephens, former Chairman and Chief Executive of Jones and Laughlin Steel Corporation, Pittsburgh, Pennsylvania, testified that he had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants, with the immaterial exception that he knew the late Harvey Hopkins, one of the defendants, when they had both been in the steel industry, but that he had had no business relationship with Mr. Hopkins at any time subsequent to 1958 or 1959 (pp. 130-5); that no one from Anchor, nor Mr. Hopkins, nor anyone else had attempted to influence his deliberations as a member of the Disinterested Quorum (p. 135); and that he felt under no pressure whatsoever from anyone at Anchor in his deliberations as a member of the Disinterested Quorum (pp. 136-7). Copies of the foregoing pages of testimony of Mr. Stephens are annexed hereto as Exhibit E.

Affidavit of Wickers in Support of Renewed Motion to Dismiss

14. Louis F. Laun, Deputy Administrator of the Small Business Administration, Washington, D.C., testified that he had no prior business or professional relationship whatsoever with anyone from Anchor or any of the defendants (pp. 148-51); that no one from Anchor had attempted to influence his deliberations as a member of the Disinterested Quorum (p. 152); and that he felt under no pressure whatsoever from anyone at Anchor with respect to his deliberations as a member of the Disinterested Quorum (p. 152). Copies of the foregoing pages of the testimony of Mr. Laun are annexed hereto as Exhibit F.

Conclusion

On the basis of the Memorandum Decision and Opinion of this Court, and on the basis of the discovery proceedings had herein, the renewed motion to dismiss this action should be granted.

s/ Roger T. Wickers

Sworn to before me
this 23rd day of July, 1976.

Affidavit of James C. Sargent Sworn to September 17, 1976 in Opposition to Renewed Motion to Dismiss

UNITED STATES DISTRICT COURT

Southern District of New York

73 Civ. 552 (HFW)

Howard M. Lasker, et ano.,

Plaintiffs,

against

Harry G. Burks, Jr., et al.,

Defendants.

State of New York }
County of New York } ss.:

James C. Sargent, being duly sworn, deposes and says:

1. I make this affidavit at the request of plaintiffs' attorneys in connection with the motion by defendants to dismiss this action.

2. I was admitted to the Bar in the State of New York in 1940 and have been a practicing attorney since that time, except for service with armed forces during World War II and as a member of the Securities and Exchange Commission thereafter. In 1955 I was appointed Regional Administrator of the Commission's New York Regional Office. Shortly thereafter, I was appointed a member of the Commission and served in that capacity from June 29, 1956

until October 21, 1960. I have been a member of the faculty of the University of Virginia Law School and have lectured throughout the country in the fields of proxy contests, securities law and corporate law generally.

3. Traditionally in the mutual fund industry, outside directors, known at various times as "unaffiliated" or "disinterested" directors, have not been independent in any meaningful sense. The absence of real independence has resulted from a variety of causes.

Typically, it is the management of a mutual fund which screens and selects outside directors. Management thereby effectively retains the power to recruit persons friendly to itself to serve as outside directors.

True independence is further negated by the pervasive control exercised by investment advisers over the investment and management functions of mutual funds. This pattern of pervasive control has existed from the very inception of the mutual fund industry and was largely responsible for many of the serious abuses which led to the enactment of the Investment Company Act.

Still another reason for the lack of independence on the part of the outside directors of a mutual fund is management's control of the fund's proxy machinery. Mutual funds are characterized by extreme diffusion of stock ownership. Such diffusion of a company's stock bears a direct relationship to the importance of the proxy machinery in the election of corporate directors—the more widely diffused the stock ownership, the greater the importance of the proxy machinery.

For example, a typical mutual fund has tens of thousands of shareholders. There are few, if any, large blocks of stock. The average shareholder's holdings in the fund are

proportionately insignificant in relation to the fund's total outstanding shares. Management, because of its control of the proxy machinery, has the power to nominate a slate of directors which invariably is elected without opposition. It costs many thousands of dollars to clear proxy material with the SEC and to make mailings to tens of thousands of fund stockholders. To defray such expense, management has at its disposal the corporate treasury. However, for an individual shareholder of a mutual fund, or for a dissident, truly "independent", outside director, a contested election in opposition to management is economically unfeasible and unrealistic since the enormous costs involved would have to be paid out of his or her own pocket. The outside directors' economic investment in the fund, if any, is so slight in relative terms that the cost of filing proxy materials and soliciting shareholders is prohibitive.

Consequently, proxy contests for control of mutual funds are virtually nonexistent. It has been, and remains, a fact in the mutual fund industry that control of the fund's proxy machinery is tantamount to control of the fund itself. The power to nominate directors in a mutual fund is tantamount to the power to elect them. The power to refuse to renominate a sitting director is tantamount to the power to remove him from office.

4. If a quorum of outside directors, comprising a minority of a mutual fund's board, is asked to make a determination on behalf of the fund and that determination might adversely affect the economic interests of the remaining directors, who comprise an absolute majority of the fund's board, and who also thereby control the fund's proxy machinery, the minority directors, in my opinion, cannot be considered truly "independent" in any meaningful sense. Under such circumstances, whether or not the minority

Affidavit of Sargent in Opposition

directors attempt to make their determination in good faith, the fact nevertheless remains that the majority directors would have the unchallengeable power to nominate, in connection with the fund's next stockholders' meeting, a slate of directors which would exclude the minority directors and thereby, for all intents and purposes, terminate their directorships.

s/ JAMES C. SARGENT

Sworn to before me
this 17th day of September, 1976.

Excerpt from Minutes of Meeting of Board of Directors of Fundamental Investors, Inc. of July 24, 1974

FUNDAMENTAL INVESTORS, INC.

MINUTES OF MEETING OF BOARD OF DIRECTORS
July 24, 1974

The regular meeting of the Board of Directors of Fundamental Investors, Inc. was held at the offices of the Fund, Westminster at Parker, Elizabeth, New Jersey, on Wednesday, July 24, 1974, at 1:30 P. M.

There were present:

Edward B. Burr
John R. Haire
S. P. Hutchison
Donald L. Kemmerer
Leon T. Kendall
Louis F. Laun
Thomas A. Martin
Mary S. O'Connor
Charles F. Phillips
Beryl Robichaud
William J. Stephens

constituting the entire Board of Directors.

There were also present Mr. Melvin Intriligator, Executive Vice President—Operations of the Fund; Mr. Roger T. Wickers, Vice President and Secretary of the Fund; Mr. Arthur M. Kesselhaut, Treasurer of the Fund; Mr. James S. Little, Assistant Vice President and Assistant Secretary of the Fund; Douglas B. Steimle, Esq., of Counsel to the Fund; and the following officers of the Investment Division

of Anchor Corporation: Mr. James J. McGonigle, Executive Vice President; Messrs. Ronald L. Welburn, Frank I. Smith, Jonathan P. White, Leonard Brooks, Jr. and Ira Ross, Vice Presidents.

Mr. Edward B. Burr, Chairman of the Board, called the meeting to order and presided, and Mr. Roger T. Wickers, Vice President and Secretary of the Fund, acted as Secretary of the meeting.

* * *

The Secretary referred to the settlement between the Fund and Goldman, Sachs & Co. executed on July 9, 1974, a copy of which had previously been sent to each director, as a result of which the Fund's suit against Goldman, Sachs & Co. was settled and discontinued. He reviewed and discussed the terms of the settlement pursuant to which the Fund sold the notes (which had been purchased by the Fund in 1969 for \$18,687,500 and valued by the Board of Directors of the Fund at \$2,000,000 since February 24, 1971, to Goldman, Sachs & Co. for \$5,250,000 in cash, representing 26.25% of the face value of the notes plus 73.75% of such amount or other consideration, if any, which Goldman, Sachs & Co. or any subsequent assignee may receive upon such notes in the reorganization of the railroad.

The Secretary then discussed the *Lasker* v. *Burks* suit against the Fund, its directors and Anchor Corporation arising out of the Fund's purchase of Penn Central Transportation Company commercial paper, and referred to the motion granted by the Court staying further proceedings in that suit pending the outcome of the Fund's suit against Goldman, Sachs & Co. He stated that because the Fund's suit against Goldman, Sachs & Co. had been settled, the stay granted by the Court in the Lasker action would expire

twenty days following the settlement of the suit against Goldman, Sachs & Co.

The Secretary said that at the time the Board of the Fund determined to commence action against Goldman, Sachs & Co. it reserved whatever rights it might have against Anchor Corporation until the final outcome of the Goldman, Sachs case. He stated that Messrs. Haire, Burr, Hutchison, Phillips and Kemmerer, among others, were named as defendants in the Lasker suit and that Mrs. O'Connor, Miss Robichaud, and Messrs. Kendall, Laun and Stephens, not being directors at the time of the Penn Central transaction, were not named as defendants.

The Board then discussed the matter following which the Board determined that the five directors who are not named as defendants in the Lasker suit and who constitute a quorum of the Board should make the decision, after consulting with independent counsel, as to what further action, if any, the Fund should take.

The Secretary stated that Judge Stanley H. Fuld, former Chief Judge of the Court of Appeals of the State of New York, had indicated his availability to consult with and advise the directors if they so desired. A discussion ensued among the five directors following which the Secretary was instructed to contact Judge Fuld and request that he review all relevant aspects of the Fund's purchase of Penn Central commercial paper, the case against Goldman, Sachs & Co., and the Lasker complaint, with a view towards meeting with the five directors on September 25th, prior to the Board meeting, for a review of his opinion as to what further action, if any, the Fund should pursue.

* * *

**Seward & Kissel Memorandum,
Dated January 6, 1975**

January 6, 1975

Memorandum to Mr. Leon T. Kendall

Mr. Louis F. Laun
Mrs. Mary S. O'Connor
Miss Beryl Robichaud
Mr. William J. Stephens

FUNDAMENTAL INVESTORS, INC.

This memorandum is intended to respond to the Board's inquiry by outlining the procedures which would have to be followed and the problems which might arise in case the Board reached the decision to terminate the Agreement (the "Agreement") for Investment Supervisory and Corporate Administrative Services between Fundamental Investors, Inc. (the "Fund") and Anchor Corporation.

1. The Board of Directors of the Fund may terminate the Agreement at any time, without penalty, on 60 days' written notice to Anchor, under the terms of the Agreement and of Section 15(a)(3) of the Investment Company Act of 1940 (the "Act"). Aside from termination, the Board could allow the Agreement to lapse by declining to approve renewal for the annual period commencing May 1, 1975. Even in such event, however, it would be advisable to give Anchor at least 60 days advance notice to avoid a claim of breach of the Agreement by the Fund.

2. If the Board were to exercise its right to terminate the Agreement, it would have to consider whether it should exercise that right with respect to the agreements with the

other six funds in the Anchor Group. The Board might decide to terminate the agreements for some but not all of the funds in the Group, although it would have to be able to offer adequate justification for such a decision.

3. The Board would have to select a new investment adviser willing and able to furnish the Fund with investment supervisory and corporate administrative services for an acceptable fee.

4. If the Board were to serve notice on Anchor of intention to terminate the Agreement before a new investment adviser was selected and agreed to serve, the Fund would have to suspend the offering of shares for sale to the public until the selection was made, since the prospects would be deficient if it did not identify the proposed new investment adviser and describe the new investment advisory agreement. For this reason, notice of termination would in any event not be given until a new adviser had been selected.

5. Following selection of a new adviser, the Board would have to call a meeting of the shareholders of the Fund, prepare and clear proxy materials with the Securities and Exchange Commission and submit the new investment advisory agreement to the shareholders at such meeting. Under the certificate of incorporation of the Fund and Section 15(a) of the Act, the agreement with the new adviser could not become effective until approved by the holders of a majority of the outstanding shares of the Fund.

6. It is possible that some shareholders of the Fund, in disagreement with the Board's decision to terminate the historic relationship with Anchor Corporation, may contest

the selection by the Board and may even nominate their own slate of directors for election at the meeting. It is also possible that a substantial number of shares of the Fund would be redeemed due to, or following the results of, such a proxy contest. The possibility of such a contest might make it more difficult for the Board to find an established investment advisor willing to assume the responsibility.

7. Preparing, filing and mailing proxy statements, holding a stockholders' meeting, amending registration statements with the SEC and all the states where the Fund is registered would impose significant additional expenses on the Fund. Similar expenses would be imposed on the other funds in the Anchor Group if their agreements were also terminated.

8. If the Board were to terminate the agreements with each fund in the Anchor Group, it might find itself in the position of having its choice of a new adviser approved by some of the funds in the Group but rejected by one or more of the others, thus requiring the Board to repeat the process of recommending another adviser until each fund had approved the selection of a new adviser.

9. If the period required for approval of the new adviser exceeded the 60 day notice period under the Agreement or if Anchor ceased to render services during such period, the Board would have to assume full responsibility for administration of the Fund, including portfolio transactions, accounting, legal, regulatory and general corporate matters. The Board would probably have to retain additional employees or one or more service companies to undertake ad-

ministrative services, since Anchor would no longer be furnishing employees for this purpose. The Fund would also have to incur office expenses which are borne by Anchor under the Agreement. During the transition period prior to the shareholders' approval of the new adviser, the Board would not be authorized to retain an investment adviser but would have to rely on employees of the Fund in making portfolio decisions. The lack of a full time, professional investment adviser during this period might, under changing market conditions, result in portfolio losses for the Fund.

s/ Eugene P. Souther

Reply Affidavit of Roger T. Wickers, Sworn to November 9, 1976 in Support of Renewed Motion to Dismiss

UNITED STATES DISTRICT COURT

SOUTHERN DISTRICT OF NEW YORK

73 Civ. 552 (HFW)

HOWARD M. LASKER, et ano.,

Plaintiffs,

against

HARRY G. BURKS, JR., et al.,

Defendants.

STATE OF NEW YORK }
COUNTY OF NEW YORK } ss.:

ROGER T. WICKERS, being duly sworn, deposes and says:

I submit this reply affidavit in support of the renewed motion to dismiss and to reply to certain inaccurate allegations made in the papers filed by plaintiffs in opposition to the renewed motion to dismiss.

1. Plaintiffs attempt to make much of the fact that I was the contact with Chief Judge Fuld, and mistakenly assert that I "retained" Chief Judge Fuld. The fact of the matter is, as plaintiffs know from the testimony of all five directors, it was those directors who retained Chief Judge Fuld—I merely performed the mechanical function of contacting him, and determining his availability. Thereafter, I gathered documentary materials and files requested by Chief Judge Fuld, arranged appointments with Anchor personnel requested by Chief Judge Fuld and, at the request

of the five directors, contacted Chief Judge Fuld to coordinate the time and place of his meeting with the five directors. At no time did I ever discuss with Chief Judge Fuld the merits of this action, his report, or any other substantive matter. Since the five directors were from different parts of the country, it would have been logistically inconvenient for them to attempt to perform these administrative functions for themselves.

2. Plaintiffs imply that the Directors Qualifications Committee may have been created for the purpose of finding and nominating directors who would be favorable to the defendants in *Lasker*—nothing could be further from the truth. The facts are these: the Directors Qualifications Committee was established in 1971 in response to shareholder questions on the procedure for selection of directors, and, more specifically, on why there were no female directors. At the time the Directors Qualifications Committee was established, the *Lasker* action, which was filed in 1973, was not even pending. The Directors Qualifications Committee, during the period 1971 through the present, has considered numerous possible candidates, and has sought, at all times, to procure the most highly qualified nominees for membership on the Board of Directors. To complete the record before this Court, annexed to this affidavit as Exhibit A are copies of excerpts of minutes from the meetings of the Board of Directors of Fundamental of July 28 and October 20, 1971, April 25 and July 25, 1973, and the excerpts of the minutes of the meetings of the Directors Qualifications Committee of March 22, 1972, April 25, May 23 and June 27, 1972, relating to the creation of the Directors Qualifications Committee and the nominations of these particular directors.

3. Finally, I respectfully call to the attention of this Court the fact that the Sargent affidavit, submitted by plain-

Reply Affidavit of Wickers in Support of Renewed Motion to Dismiss

tiffs as part of their papers in opposition to the renewed motion to dismiss, is mere personal opinion. Fundamental disagrees with the opinion expressed (i.e., that there is no such thing as a disinterested director of a mutual fund) but, more to the point, Fundamental wishes to record its position that the Sargent affidavit is entirely irrelevant to the sole issue left open by this Court, i.e., whether or not *these* five directors were truly disinterested and independent. Mr. Sargent, to the best of my knowledge, has never met with any of the five directors, nor does his affidavit indicate that he reviewed any of the pleadings, depositions, or other papers in this action. Accordingly, his affidavit should be given no weight on this renewed motion to dismiss.

s/ Roger T. Wickers

Sworn to before me this
9th day of November, 1976.

Appendix A to Reply Memorandum in Support of Renewed Motion to Dismiss—Chart of Relationship of Disinterested Directors and Defendants

Disinterested Director—William J. Stephens

Defendants	*Known to Stephens when he became a director*
Harry G. Burks, Jr.	No
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	No
Harvey C. Hopkins*	Yes
S. P. Hutchison	No
Donald L. Kemmerer*	No
A. S. Mike Monroney	No
Charles F. Phillips	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Mary S. O'Connor	No
Dr. Beryl Robichaud	No
Leon T. Kendall	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—MARY S. O'CONNOR

Defendants	*Known to O'Connor when she became a director*
Harry G. Burks, Jr.*	Yes
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	Yes
Harvey C. Hopkins	No
S. P. Hutchison	No
Donald L. Kemmerer	No
A. S. Mike Monroney	No
Charles F. Phillips*	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Dr. Beryl Robichaud	Yes
William J. Stephens	No
Leon T. Kendall	Yes

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—LOUIS F. LAUN

Defendants	*Known to Laun when he became a director*
Harry G. Burks, Jr.*	No
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	No
Harvey C. Hopkins	No
S. P. Hutchison	No
Donald L. Kemmerer	No
A. S. Mike Monroney	No
Charles F. Phillips*	Yes
Jeptha H. Wade	No
Members of Disinterested Quorum	
Mary S. O'Connor	No
Dr. Beryl Robichaud	No
William J. Stephens	No
Leon T. Kendall	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—LEON T. KENDALL

Defendants	*Known to Kendall when he became a director*
Harry G. Burks, Jr.	Yes
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	Yes
Harvey C. Hopkins	No
S. P. Hutchison	No
Donald L. Kemmerer*	No
A. S. Mike Monroney	No
Charles F. Phillips	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Mary S. O'Connor	Yes
Dr. Beryl Robichaud*	No
William J. Stephens	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

Chart

DISINTERESTED DIRECTOR—DR. BERYL ROBICHAUD

Defendants	*Known to Robichaud when she became a director*
Harry G. Burks, Jr.	No
Edward B. Burr	No
Thomas F. Chalker	No
John R. Haire*	No
Harvey C. Hopkins*	No
S. P. Hutchison	No
Donald L. Kemmerer*	No
A. S. Mike Monroney	No
Charles F. Phillips	No
Jeptha H. Wade	No
Members of Disinterested Quorum	
Louis F. Laun	No
Mary S. O'Connor	Yes
Leon T. Kendall	No
William J. Stephens	No

* Asterisk indicates members of the Directors' Qualifications Committee who proposed names to full Board of Directors for nomination as a director.

ORDERS OF COURT OF APPEALS

Orders of Court of Appeals, March 9, 1978, Denying Rehearing and Rehearing in banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Docket No. 77-7060

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the ninth day of March, one thousand nine hundred and seventy-eight.

Present:

HON. J. EDWARD LUMBARD
HON. JAMES L. OAKES
HON. THOMAS J. MESKILL,
Circuit Judges.

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

v.

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, etc.,

Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the defendants-appellees.

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

s/ A. DANIEL FUSARO,
Clerk

Orders of Court of Appeals, March 9, 1978, Denying Rehearing and Rehearing in Banc

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

Docket No. 77-7060

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the ninth day of March, one thousand nine hundred and seventy-eight.

HOWARD M. LASKER and IRVING GOLDBERG,

Plaintiffs-Appellants,

v.

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, etc.,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the defendant-appellees, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

s/ IRVING R. KAUFMAN
Chief Judge

IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO THE PETITION

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Of Counsel

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1977

No. 77-1724

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Petitioners,

v.

HOWARD M. LASKER and IRVING GOLDBERG,

Respondents.

RESPONDENTS' BRIEF IN OPPOSITION TO THE PETITION

Question Presented

Can minority directors of a registered mutual fund who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act terminate a validly commenced nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser based upon violations of the Act and other breaches of fiduciary duties?

Statutory Provisions Involved

The following statutory provisions are involved:

Section 36 of the Investment Company Act as it existed prior to December 14, 1970, Act of Aug. 22, 1940, ch. 686, Title I, §36, 54 Stat. 841;*

Section 13(a)(3) of the Investment Company Act, codified in 15 U.S.C. §80a-13(a)(3) (1976) (at p. 1027);

Section 206 of the Investment Advisers Act, codified in 15 U.S.C. §80b-6 (1976) (at p. 1070);

Rule 23.1 of the Federal Rules of Civil Procedure.

Statement of the Case

This is a stockholder's derivative action brought on behalf of Fundamental Investors, Inc. ("the Fund"), a federally regulated mutual fund, seeking redress for investment losses of $20 million in connection with the Fund's purchase and retention of commercial paper issued by the now bankrupt Penn Central Transportation Company. The Fund's investment adviser and certain of the Fund's present and former directors are charged with gross misconduct, gross abuse of trust, fraud and deviation from the Fund's fundamental investment policy. The claims asserted arise under the Investment Company Act of 1940, the Investment Adviser's Act and the common law.

The Fund is an open-end mutual fund and is one of seven funds within the Anchor Group of Mutual Funds.

* Petitioners and the *amici* cite and refer to the current statute, commonly referred to as Section 36 of the Investment Company Act, codified in 15 U.S.C. §§80a-35(a) and (b). That statute was enacted after the events giving rise to this litigation occurred. Petitioners have violated Rule 23(1)(d) of this Court by failing to reproduce any of the statutes involved.

Petitioner Anchor Corporation ("Anchor") is the Fund's investment adviser. The individual petitioners are the directors who were members of the Fund's board at the time the acts complained of occurred.

During the period November 28 through December 8, 1969, the Fund purchased $20 million worth of 270-day Penn Central commercial paper in four separate transactions. The paper was purchased from Goldman, Sachs & Company, which Anchor believed had conducted a credit analysis of the issuer. Goldman, Sachs sold the paper as a principal out of its own inventory. Notwithstanding its duty, as a highly paid adviser, to render independent advisory recommendations, Anchor concededly did not conduct any independent analysis or investigation, either at the time of purchase or thereafter. In this regard the Court of Appeals stated:

> "It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment."*

Not only were the purchases made without any investigation but, in addition, two primary investment policies of the Fund itself were violated:

The Fund failed to obtain a required buy-back commitment;

* *Lasker* v. *Burks*, 567 F.2d 1208, 1209 (2d Cir. 1978). Indeed, even staggering first quarter 1970 losses of $62.7 million reported in the *Wall Street Journal* on April 23, 1970 failed to prompt Anchor to action. It is difficult to imagine a more blatant unawareness of an impending disaster by a highly paid and purportedly sophisticated adviser than that exhibited by Anchor.

The Fund failed to restrict its holdings to not more than ten (10%) percent of the issue.

Based upon the facts before it, the Court of Appeals concluded:

> "From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits the defendants would be found free from liability for the Fund's losses." 567 F.2d at 1210.

After the Penn Central debacle in June 1970, the Fund determined to proceed against Goldman, Sachs and adopted a resolution to that effect in November 1970. The November 1970 resolution specifically held in abeyance the question of whether to proceed against Anchor.*

The present action was commenced in February 1973** but was stayed pending determination of the Fund's action against Goldman, Sachs. That action was settled in July 1974 with the Fund recouping only approximately twenty-five (25%) percent of the $20 million dollars which it lost.

Thereafter, an alleged independent minority of the board, acting on the advice of Special Counsel, determined that this action should be abated because further prosecution was not in the best interests of the Fund. A motion was made and the District Court dismissed*** but was re-

* It must be remembered that Anchor dominated the Fund.

** The complaint alleged that demand was unnecessary. Defendants have never disputed that allegation. Because of the procedural maneuvers of the defendants, the complaint has yet to be answered and plaintiffs have not had any discovery on the merits.

*** The dismissal came after limited discovery led the District Court to conclude that the minority was "independent and disinterested." *Lasker* v. *Burks,* 426 F. Supp. 844 (S.D.N.Y. 1977).

versed by the Court of Appeals, which concluded that the alleged disinterested directors lacked the power to terminate this litigation.*

POINT I

There Is No Reason for Review by This Court Since the Result Below Is Consistent With Well Accepted Principles Governing the Maintenance of Derivative Actions.

Petitioners suggest that the determination of the Second Circuit, which prevented a *minority* of a board from abating a validly commenced derivative action, somehow flies in the face of existing precedent. On the contrary, it is well settled that even a *majority* of a board cannot abort a validly commenced derivative action which has proceeded beyond the threshold issue of demand, as has this case. See *Birnbaum* v. *Birrell,* 17 F.R.D. 409 (S.D.N.Y. 1955); *Berger* v. *Dyson,* 111 F. Supp. 533 (D.R.I. 1953); *Denicke* v. *Anglo California Nat. Bank,* 45 F. Supp. 524, 529 (N.D. Cal. 1942), *aff'd,* 141 F.2d 285 (9th Cir.), *cert. denied,* 323

* The tactic adopted to obtain dismissal was carefully planned and orchestrated. By November 1970, Anchor was aware that the Fund had potential claims against it. In July 1971, at the suggestion of Mr. Haire (the President of the Fund and Chairman of Anchor) a committee to screen who would become independent directors of the Fund was created. This committee was dominated by Haire and consisted solely of defendants except in one situation where two of the three members were defendants. The independent directors who eventually determined to seek dismissal of this action were nominated by the full board (including the malefactors) after prior screening by that committee. The "independent" directors serve not only on the Fund's board but on the boards of its sister funds, each receiving remuneration of approximately $11,000 to $13,000 per year. Naturally, Mr. Haire and his confederates sit with them on these other boards.

U.S. 739 (1944); 3B Moore, FEDERAL PRACTICE ¶23.1.24[2] at p. 23.1-138.*

Indeed, it is also well settled that where, as here, a majority of the board is charged with wrongdoing or is controlled by a wrongdoer demand pursuant to F.R.C.P. 23.1 is excused. See *Liboff* v. *Wolfson*, 437 F.2d 121, 122 (5th Cir. 1971); *Levitt* v. *Johnson*, 334 F.2d 815, 817 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965); *Swanson* v. *Traer*, 249 F.2d 854, 856, 858-59 (7th Cir. 1957); *Cathedral Estates, Inc.* v. *Taft Realty Corp.*, 228 F.2d 85, 88 (2d Cir. 1955); *Jannes* v. *Microwave Communications, Inc.*, 57 F.R.D. 18, 21 (N.D.Ill. 1972); *Barr* v. *Wackman*, 36 N.Y.2d 371, 379, 368 N.Y.S. 2d 497, 505 (1975); Note, "Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit," 73 HARV. L. REV. 746, 747 (1960). The clear import of these cases (and the many others of similar ilk) is that a *minority* of the board simply cannot prevent derivative actions against a wrongoing majority. Obviously, if the minority cannot prevent commencement, it similarly cannot cause termination.**

* Even if the minority directors had the power to act—which they do not—Rule 23.1 of the Federal Rules of Civil Procedure would itself require prior notice to the shareholders and a judicial determination that dismissal was fair. *Norman* v. *McKee*, 431 F.2d 769, 774 (9th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971). Any such determination could be made only after adequate discovery (*Saylor* v. *Lindsley*, 456 F.2d 896, 904-05 (2d Cir. 1972); *Weiss* v. *Chalker*, 55 F.R.D. 168, 169 (S.D.N.Y. 1972)) and court evaluation of the merits (*Fricke* v. *Daylin, Inc.*, 66 F.R.D. 90 (E.D. N.Y. 1975); *Cannon* v. *Texas Gulf Sulphur Co.*, 55 F.R.D. 308, 315-16 (S.D.N.Y. 1972)). Here, even without any discovery, the Court of Appeals was able to find merit in the pending action.

** The cases cited by Investors Diversified Services hold only that a board of directors may not exercise discretion with respect to derivative litigation unless there is a qualified independent majority. See *Heit* v. *Baird*, 567 F.2d 1157, 1160-61 (1st Cir. 1977); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264-65 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Independent Investor Protective League* v. *Saunders*, 64 F.R.D. 564, 571 (E.D. Pa. 1974); *Abrams* v. *Mayflower Investors, Inc.*, 62 F.R.D. 361, 368 (N.D. Ill. 1974); *Lerman* v. *ITB Management Corp.*, 58 F.R.D. 153, 157 (D. Mass. 1973); *Baffino* v. *Bradford*, 57 F.R.D. 79, 80 (D. Minn. 1972). It would make little sense to leave control of the action in the hands of a minority which is subject to great pressure and control by the malefactors who comprise the majority. See *Hall* v. *M.B. O'Reilly Realty & Inv. Co.*, 306 Mo. 182, 196, 267 S.W. 407, 411 (1924); *Tillis* v. *Brown*, 154 Ala. 403, 406-07, 45 So. 589, 590 (1908)

The assertion that the decision below conflicts with the decisions of this Court in *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903) and *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917) is erroneous. These cases simply uphold the general authority of a board of directors to determine whether corporate claims should be pursued. Neither case, however, involved a minority of a board seeking to abort an action validly commenced against a wrongdoing majority. Indeed, in *United Copper* Justice Brandeis stated that a board of directors is without authority to exercise discretion where the wrongdoers control the corporation, as do the individual defendants here. 244 U.S. at 264.

Equally erroneous is the suggestion that the result below conflicts with the decisions of this Court in *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462 (1977) and *Cort* v. *Ash*, 422 U.S. 66 (1975). Both *Santa Fe* and *Cort* concerned the question of the existence of implied federal claims which, if recognized, would have overridden substantive state corporate law. In the present case petitioners have never questioned the existence of a federal implied right of action,* which here arises out of the failure of a registered professional to conduct an adequate investigation in connection with a $20 million investment.

* See *Abrahamson* v. *Fleschner*, 568 F.2d 862, 873 (2d Cir. 1977), *cert. denied*, 46 U.S.L.W. 3710 (May 16, 1978) and cases cited therein.

Indeed, this is a traditional area of concern under the federal securities laws. See *Feeney* v. *Securities and Exchange Commission*, 564 F.2d 260, 262 (8th Cir. 1977), *cert. denied*, 46 U.S.L.W. 3649 (Apr. 10, 1978); *Franklin Savings Bank of New York* v. *Levy*, 551 F.2d 521, 527 (2d Cir. 1977); *Hanly* v. *Securities and Exchange Commission*, 415 F.2d 589, 595-97 (2d Cir. 1969); *Matter of Winfield & Co., Inc.*, CCH FED. SEC. L. REP. [1971-72 Transfer Binder] ¶78,530 at p. 81,147 (S.E.C. 1972).

Santa Fe and *Cort* present the issue of whether Congress intended to invade traditional areas of state control of corporate affairs by substantive legislation. The decision below merely prevented petitioners from utilizing a contrived procedural ploy to evade substantive liability arising under federal and state law.*

Indeed, contrary to petitioners' assertions, Delaware law** does not sanction the procedural contrivance attempted by petitioners. Petitioners cite no Delaware case in which a disqualified majority of a board of directors was permitted to delegate to its minority members the authority to act with respect to derivative litigation. To the contrary, under Delaware law, where the litigation, if brought by the corporation itself, would be subject to the control of the alleged wrongdoers a shareholder cannot be precluded from prosecuting the corporate claim. See *Sohland* v. *Baker*, 15 Del. Ch. 431, 441, 141 Atl. 277, 281-82

* Mr. Eisenberg, counsel in this case for the Investment Company Institute, has previously written with respect to the Investment Company Act, and Section 36 in particular, that, "Shareholder rights in such a suit are based on federal law and should not be impeded by corporate or state devices designed to frustrate or unreasonably burden derivative suitors." Eisenberg & Lehr, "An Aspect of the Emerging 'Federal Corporation Law': Directorial Responsibility Under the Investment Company Act of 1940," 20 RUTGERS LAW REV. 181, 225 (1966) (footnotes omitted).

** The Fund is a Delaware corporation.

(1927); *McKee* v. *Rogers*, 18 Del. Ch. 81, 85-86, 156 Atl. 191, 193 (1931); *Satterthwaite* v. *Eastern Bankers' Corp.*, 17 Del. Ch. 310, 312, 154 Atl. 475, 476 (1931).*

It is also clear that under Deleware law directors may not sanction or ratify the perpetration of fraudulent or illegal acts by their co-directors. See *Bennett* v. *Propp*,

* Investors Diversified Services erroneously attributes unfettered control of derivative litigation to the board of a corporation. In support of this overly broad statement it cites *Davis* v. *Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 142 Atl. 654 (1928); *Ella M. Kelly & Wyndham, Inc.* v. *Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz* v. *Bantrell*, 41 Del. Ch. 177, 190 A.2d 749 (1963); *Beard* v. *Elster*, 39 Del. Ch. 153, 160 A.2d 731 (1960); and *Puma* v. *Marriott*, 283 A.2d 693 (Del. Ch. 1971). However, these cases have nothing to do with board determinations regarding the maintenance of derivative actions, but rather involve the application of the business judgment rule as a substantive defense to charges of directorial misconduct. In fact, federal law controls the question of whether a board of directors is qualified to exercise discretion with respect to derivative litigation seeking the vindication of federal rights in a federal court. See *Meltzer* v. *Atlantic Research Corp.*, 330 F.2d 946, 948-49 (4th Cir.), *cert. denied*, 379 U.S. 841 (1964); *Walden* v. *Elrod*, 72 F.R.D. 5, 13 (W.D. Okla. 1976); *Belcher* v. *Birmingham Trust Nat'l Bank*, 348 F.Supp. 61, 142 (N.D. Ala. 1968). Thus, even if state law conflicted with federal law on this issue, which it does not, federal law would prevail. This is further confirmed by the express provisions of Section 1(a) of the Investment Company Act, 15 U.S.C. §80a-1(a), which provides:

> "(a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z-4 of this title, and facts otherwise disclosed and ascertained, it is found that investment companies are affected with a national public interest in that, among other things—
>
> * * *
>
> (5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders make difficult, if not impossible, effective State regulation of such companies in the interest of investors."

See also *Rosenfeld* v. *Black*, 445 F.2d 1337, 1345 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802 (1972); Nutt, "A Study of Mutual Fund Independent Directors," 120 U. PA. L. REV. 179, 205 (1971-72).

41 Del. Ch. 14, 187 A.2d 405, 411-12 (1962); *Toebelman* v. *Missouri-Kansas Pipe Line Co.,* 130 F.2d 1016, 1022 (3d Cir. 1942); *Keenan* v. *Eshelman,* 23 Del. Ch. 234, 2 A.2d 904 (1938). That, however, is precisely what the minority sought to accomplish by its decision to abort further judicial consideration of this matter. The Supreme Court of Delaware said in the leading case of *Mayer* v. *Adams,* 37 Del. Ch. 298, 304, 141 A.2d 458, 461 (1958):

> "[A] decision not to press a claim for alleged fraud committed by the directors means, in effect, that the wrong cannot be remedied. It is conceded that the wrong cannot be ratified by the majority stockholders, but it is said that refusal to sue is a different thing from ratification. Strictly speaking, this is true, but the practical result is the same."

Consequently, even under Delaware law, the minority directors cannot ratify the acts in question and thus are without authority to prevent this action from going forward.*

There is no authority under Delaware law which permits directors charged with serious wrongdoing to choose the forum in which they shall be judged, handpick the judge and jury, and in the absence of judicial process be the sole arbiters of what information should be disclosed for consideration in determining their guilt or innocence. That is precisely what was done here, no matter how euphemistically petitioners wish to describe it.

* See also *Arthur Lipper Corp.* v. *S.E.C.,* 547 F.2d 171, 179 (2d Cir. 1976), *cert. denied,* 46 U.S.L.W. 3436 (Jan. 9, 1978); *Fisher* v. *Nat'l Mortg. Loan Co.,* 132 Neb. 185, 271 N.W. 433 (1937); *Continental Securities Co.* v. *Belmont,* 206 N.Y. 7, 17-19, 99 N.E. 138, 142-43 (1912); Note, "Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit," 73 Harv. L. Rev. 746, 762 (1960).

The result below is clearly in accord with well established principles of corporate law governing the maintenance of derivative actions. There is nothing in either the decisions of this Court or of the courts of Delaware which even remotely suggests that petitioners' procedural gambit should succeed. Accordingly, there is no reason why this matter should be reviewed by this Court.

POINT II

There Is No Reason for Review by This Court Since the Result Below Does Not Conflict With Decisions in Other Circuits as to the Proper Role of Mutual Fund Directors. The Decision Is Consistent With the Statutory Scheme of the Investment Company Act and Will Not Create Hardship in the Operation of Mutual Funds.

A. *There Is No Conflict With Other Decisions.*

Petitioners assert that the determination below conflicts with the First Circuit's decision in *In re Kauffman Mutual Fund Actions,* 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973) and with prior decisions within the Second Circuit itself, namely *Fogel* v. *Chestnutt,* 533 F.2d 731 (2d Cir. 1975), *cert. denied,* 429 U.S. 824 (1976) and *Tannenbaum* v. *Zeller,* 552 F.2d 402 (2d Cir.), *cert. denied,* 98 S.Ct. 421 (1977).

Petitioners made the same argument before the Second Circuit in connection with their petition for a rehearing in banc. In denying that petition the Court stated that "no active judge or judge who was a member of the panel . . . requested that a vote be taken . . . ." Thus, petitioners' argument as to alleged conflict was not even deemed sufficiently worthy to warrant that a vote be taken. It is equally

unworthy of consideration by this Court. The purported conflicts simply do not exist.

The *Kauffman* case, chiefly relied upon by petitioners, involved a derivative antitrust claim on behalf of a mutual fund. The issue was whether a demand on the board of directors was excused under F.R.C.P. 23.1.* The court in *Kauffman* upheld the necessity of a demand because, unlike here, a majority of the directors were not defendants in the action and, indeed, were not even alleged to have approved the acts complained of. 479 F.2d at 264-65.

The court in *Kauffman* determined, in effect, that the independent mutual fund directors should have been given an opportunity to exercise discretion. As majority directors not charged with misconduct, they were able to exercise discretion with respect to a demand in the context of Rule 23.1. In the present case, the Second Circuit simply determined that a minority of independent directors could not terminate validly commenced litigation. There is no conflict between the two decisions.**

Nor does the decision below conflict with the *Fogel* and *Tannenbaum* cases, both of which dealt with the matter of recapture of brokerage fees. Neither *Fogel* nor *Tannenbaum* involved the issue of discretionary authority to terminate derivative litigation and in neither case did the wrongdoing defendants constitute a majority of the board of directors. 533 F.2d at 746n.15; 552 F.2d at 411.*

* As previously indicated, and as noted by the District Court, defendants here have never disputed the fact that a demand in the instant case was excused. See *Lasker* v. *Burks,* 404 F.Supp. 1172, 1178 (S.D.N.Y. 1975).

** *Kauffman* was recently reaffirmed by the First Circuit in *Heit* v. *Baird,* 567 F.2d 1157, 1160 n.4 (1st Cir. 1977), wherein the court expressly noted that, "*Kauffman* has been cited with approval by the Second Circuit, where many derivative suits are brought." Similarly, in *Brooks* v. *American Export Industries, Inc.,* 68 F.R.D. 506, 510 (S.D.N.Y. 1975) the district court observed that, "The *Kauffman* case, which discusses in detail the extent of the 'futility' exception, has been repeatedly cited with approval by the Second Circuit."

The gravamen of the offense in these cases was management's failure to make full and effective disclosure to the independent directors concerning the availability of recapture through various business mechanisms. The court found that full disclosure had to be made to the independent directors (who constituted a majority) and then noted that once such disclosure was made, the question of whether to pursue recapture could be determined by the independent directors provided that they were in fact independent.

The issue in these recapture cases was not whether suit should be brought for past wrongs but whether certain business steps should be taken to obtain future benefits. In the case at bar the question presented is whether suit should proceed against Anchor for its prior illegal and fraudulent acts. The Second Circuit here held that a minority of the board could not prevent suit. Indeed, in both *Fogel* and *Tannenbaum,* the Court indicated that once a wrong has been committed, as it was here, it may not be excused, ratified or condoned by subsequent acts, expressions or determinations of the independent directors. 533 F.2d at 750; 552 F.2d at 429n.31. See also *Arthur Lipper Corp.* v. *S.E.C.,* 547 F.2d 171, 179 (2d Cir. 1976), *cert. denied,* 46 U.S.L.W. 3436 (Jan. 9, 1978), where the Court stated:

* Similarly, in neither of the other two cases cited by the *amici curiae* with respect to a purported conflict did the wrongdoing defendants constitute a majority of the board. See *Moses* v. *Burgin,* 445 F.2d 369, 371 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Untermeyer* v. *Fidelity Daily Income Trust,* CCH Fed. Sec. L. Rep. ¶96,419 at 93,512-13 (D. Mass. 1978).

"Moreover, it is not within the competence of a board of directors of an investment company to sanction the perpetration of a fraud by the manager. *Cf. Schoenbaum* v. *Firstbrook, supra,* 405 F.2d at 219-20; *Drachman* v. *Harvey,* 453 F.2d 722, 736-38 (2 Cir. 1972) (*en banc*). Indeed, it would seem that only a unanimous shareholder vote could ratify a fraud of this type even if approved by directors. See Ballantine on Corporations §71, at 177 (rev. ed. 1946); Cary, Cases and Materials on Corporations 591-92 (1969); Lattin, Jennings & Buxbaum, Corporations 821 (1968 ed.); *Keenan* v. *Eshelman,* 23 Del. Ch. 234, 2 A.2d 904 (Sup. Ct. 1938); *Continental Securities Co.* v. *Belmont,* 206 N.Y. 7, 99 N.E. 138 (1912)."

There is no conflict between the decisions of the Second Circuit in *Tannenbaum* and *Fogel* and the decision of that circuit in this case.

B. *The Decision Below Is Consistent With the Statute and Creates No Undue Problems.*

Petitioners and the *amici curiae* argue that the Court of Appeals misconstrued the Investment Company Act, particularly the 1970 amendments thereto, and in so doing undermined the watchdog function intended by Congress for independent mutual fund directors. This argument lacks any basis whatsoever.

As previously demonstrated, an independent minority of a board of directors of a business corporation is without power, under federal or state decisional law, to obtain dismissal of derivative litigation. The question which the Court of Appeals focused upon in the present case was whether the Investment Company Act conferred special power on minority independent mutual fund directors so as to permit them to abort a derivative action in a situa-

tion where directors of other kinds of business corporations could not do so. The Court not only found that such power did not exist, but rather found that the policy of the Act militated against it. The Court stated:

"We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties." 567 F.2d at 1210.*

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* Congress mandated in Section 1(b) of the Investment Company Act, 15 U.S.C. §80a-1(b), that the Act be interpreted so as to maximize the protection of shareholder interests, particularly where, as here, those interests directly conflict with the financial interests of the managing directors and the investment adviser. The Act provides:

"(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z—4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

• • •

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes

Petitioners and the *amici* suggest that the Court of Appeals imputed into the provisions of Section 36(a) the broader provisions of Section 36(b) with respect to the commencement of derivative actions. This argument is specious because those statutory provisions were not even in existence when the wrongs at bar occurred and this case does not rest upon them but rather upon Section 36 as it read prior to its amendment effective December 1970.

As suggested by petitioners and the *amici,* the 1970 amendments were intended to strengthen the role of in-

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> of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;
>
> • • •
>
> It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors."

See *Levitt* v. *Johnson,* 334 F.2d 815 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965). Moreover, under Section 17(h) of the Act, 15 U.S.C. §80a-17(h), Congress specifically prohibited clauses in corporate instruments, including the by-laws, which protect or purport to protect mutual fund directors from liability. Section 17(h) states in part:

> "(h) After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."

See *Chabot* v. *Empire Trust Co.,* 301 F.2d 458 (2d Cir. 1962); *Brown* v. *Bullock,* 194 F.Supp. 207, 237-38 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

dependent directors in dealing with the adviser.* Nothing in the language or legislative history of those sections, however, can be construed as granting independent directors extraordinary powers to curtail existing shareholder rights, including the right to sue derivatively. The creation of a watchdog role for the independent directors cannot and should not be distorted into the creation of a power to exculpate wrongdoing directors under the guise of business judgment.

In its brief to this Court, the Investment Company Institute asserts that maintenance of this action will somehow impair Anchor's ability to function as the Fund's adviser. To the contrary, Mr. Haire testified at his deposition:

> "Q. Did you have an opinion whether your firm, Anchor, could continue as the adviser in the event these five people decided to continue the suit against you?
>
> A. I certainly did. I would have argued most vigorously that we could continue to serve.
>
> Q. That you could?
>
> A. That is correct."

Petitioners and the *amici* suggest that the effect of the Court of Appeals' decision will be to encourage unfounded

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* A primary purpose of the 1970 amendments was to strengthen the negotiating hand of the independent directors vis-a-vis the adviser by making it clear that a shareholder's right of action would lie in the event the advisory or underwriting fees were excessive. See S. Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* 3 U.S. Code Cong. & Admin. News 4897, 4901-4903 (1970). The decision by the Court of Appeals in this case has done nothing to impair the strengthened position of the independent directors nor to impede the fulfillment of the congressional purposes behind the 1970 amendments. To the contrary, it has bolstered that position.

suits against investment advisers each time an investment results in a loss. The simple fact, however, is that the present action is "nonfrivolous" and is based upon established statutory and common law standards. How the permitted maintenance of a nonfrivolous action will encourage unfounded actions is nowhere explained. Concededly, litigation causes some corporate disruption. However, the Investment Company Act, Rule 23.1 and the common-law sanction derivative claims such as the one at bar.

Investors Diversified Services predicts a vast expansion in mutual fund derivative litigation because, in its view, the Court of Appeals has created a presumption that "independent" directors are not sufficiently disinterested to abate nonfrivolous derivative actions. No such presumption was created. Rather, the Court ruled that on the specific facts at bar,

> ". . . it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires." 567 F.2d at 1212.

In reaching this conclusion, the Court was motivated by at least four factual considerations: (1) the quorum which made the determination constituted only a minority of the board; (2) the Fund is a corporate shell, organized, administered and controlled by Anchor and the majority defendants; (3) the independent directors were selected, nominated and held office at the pleasure of the majority defendants; and (4) the minority directors received remuneration of from $11,000 to $13,000 per year for serving on the Fund's board and the boards of six other Anchor controlled corporations. The Court's conclusion

that independent directors of mutual funds "do not have the power to foreclose the continuance of nonfrivolous litigation brought by shareholders against majority directors" is merely a recognition of the corporate reality that in such a situation effective control rests with the parties charged with the wrongdoing.* Thus, while the decision may be couched in terms of the Investment Company Act it is basically a corporate law determination founded on the most well settled general principles. See *Liboff* v. *Wolfson, supra,* 437 F.2d at 122; *Cathedral Estates, Inc.* v. *Taft Realty Corp., supra,* 228 F.2d at 86; *Dopp* v. *American Electronic Laboratories, Inc.*, 55 F.R.D. 151 (S.D.N.Y. 1972); *Cohen* v. *Industrial Finance Corp.*, 44 F. Supp. 491 (S.D.N.Y. 1942); *Ripley* v. *Internat. Rys. of Cent. Amer.*, 8 App. Div. 2d 310, 314-18, 188 N.Y.S.2d 62, 69-73 (1st Dep't 1959), *aff'd,* 8 N.Y.2d 430, 209 N.Y.S. 2d 289 (1960). See also *Commonwealth Coatings Corp.* v. *Continental Casualty Co.*, 393 U.S. 145 (1968); *Borden* v. *Sinskey,* 530 F.2d 478, 495 (3d Cir. 1976).

There is no basis for the argument that the present decision will expand derivative litigation.

Finally, Investors Diversified Services argues that the procedure employed by the Fund's board for the review and dismissal of this case is a viable, and indeed preferable, alternative to the demand procedures embodied in F.R.C.P. 23.1. The argument is devoid of substance. If the procedure suggested by IDS were sanctioned, Rule 23.1 would be rendered meaningless. A derivative plain-

* In a mutual fund control of the board obviously carries full control of the proxy machinery and the corporation. Wharton School of Finance & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. at 64 (1962); Securities & Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. at 129-30 (1966)

tiff could enter the courthouse one day by successfully pleading futility of demand against a wrongdoing majority only to find himself being escorted out the courthouse door at some subsequent point in the litigation by a minority of the same disqualified board. The potential for abuse would be enormous. A controlling majority of defendant directors could create a disinterested quorum after the litigation had commenced by rotating themselves out of office until a quorum perceived as friendly were available to exercise business judgment. As stated by the court in *Cohen* v. *Industrial Finance Corp., supra:*

> "The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder, after accusations of wrongoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority." 44 F.Supp. at 494.

See also *Meltzer* v. *Atlantic Research Corp.,* 330 F.2d 946, 949 (4th Cir.), *cert. denied,* 379 U.S. 841 (1964).*

* If the procedure in question were sanctioned, it would be almost impossible to ferret out abuses on a case by case basis, particularly as regards mutual funds. The court in *Boyko* v. *The Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975), stated, "[T]angible indications of bias on the part of the unaffiliated majority [here, minority] are rarely present. As stated in the legislative history, control of a mutual fund by its adviser is the result of intangible factors arising out of the unique structure of the industry." One commentator put the matter as follows: "[O]bviously you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours. . . ." *Conference on Mutual Funds,* 115 U. Pa. L. Rev. 662, 739 (1967) (remarks of Abraham L. Pomerantz). See also Nutt, "A Study of Mutual Fund Independent Directors," 120 U. Pa. L. Rev. 179, 216 (1971-72); Wharton School of Finance and Commerce, *A Study of Mutual Funds,* H.R. Rep. No. 2274, 87th Cong., 2d Sess. 465-66 (1962).

APPENDIX

Contrary to the argument put forth by Investor Diversified Services, had the procedure adopted by the Fund's board been judicially sanctioned, it would have provided an effective device for the frustration of shareholder enforcement of important federal prophylactic legislation and a means for corporate fiduciaries to absolve themselves from serious charges of wrongdoing.

CONCLUSION

For the foregoing reasons, the petition should be denied.

Respectfully submitted,

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APPENDIX

Investment Company Act of 1940

§13. Changes in investment policy

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

* * *

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a—8(b) (3) of this title:

§36. Breach of fiduciary duty [Effective prior to December 14, 1970]

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts—

(1) as officer director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall

enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

Investment Advisers Act

§206. Prohibited transactions by investment advisers

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Federal Rules of Civil Procedure

Rule 23.1 Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

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Respondents.

PETITIONERS' REPLY

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In our Petition, we showed (1) that this case presents an important question of federal law that has not been, but should be, decided by this Court; (2) that the decision of the United States Court of Appeals for the Second Circuit is in conflict with prior decisions of this Court and another Court of Appeals; and (3) that the decision of the Court of Appeals has no basis in the Investment Company Act of 1940 and its legislative history.

Respondents'* Brief in Opposition now abandons the opinion of the Court of Appeals and seeks to justify the result below on entirely different grounds. Thus, plaintiffs argue (Brief in Opposition, p. 19):

> "... while the decision may be couched in terms of the Investment Company Act it is basically a cor-

* In this Reply, as in the Petition, respondents are referred to as "plaintiffs" and petitioners as "defendants".

porate law determination founded on the most well settled general principles."

Defendants and the District Court—not plaintiffs—relied on "well settled general principles." These principles were rejected by the Court of Appeals in footnote 14 (567 F.2d at 1212, n.14):

> ". . . the plethora of cases cited by counsel dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed.R.Civ.P. 23.1 are inapposite. We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations."

State and federal corporate law decisions—including those involving mutual funds—emphasize the importance of determining whether the directors who make decisions on behalf of a corporation are independent. Thus, the Court of Appeals had to deal with the District Court's findings of fact that each of the directors constituting the quorum to which Fundamental's board delegated the responsibility for deciding whether to pursue plaintiffs' proposed lawsuit was truly disinterested and independent. This the Court of Appeals did by relying on selected portions of the Investment Company Act of 1940 to buttress its ruling that, *as a matter of law*, no director of an investment company in circumstances such as those presented here could ever be considered independent.

As shown in defendants' Petition and the *amicus curiae* briefs submitted by other concerned parties, for this Court to leave such a clearly erroneous construction of the Investment Company Act of 1940 standing would have seriously deleterious effects upon the mutual fund industry. It would also leave standing a legally improper and inequitable result in the instant case, with potentially important precedential effects for other similar actions.

Reply to Plaintiffs' Point I

1. Plaintiffs argue that demand under Rule 23.1. Fed.R.Civ.P. (hereinafter "Rule 23.1") was allegedly excused, and, accordingly, the quorum of independent directors could not decide to terminate the action. Thus, they write (Brief in Opposition. p. 6):

> "Obviously, if the minority cannot prevent commencement, it similarly cannot cause termination."

No case so holds, and several decisions contradict that conclusion. See, e.g., *Wolf* v. *Barkes,* 348 F.2d 994, 997 (2d Cir.), *cert. denied,* 382 U.S. 941 (1965); *Alleghany Corp.* v. *Kirby,* 344 F.2d 571 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28 (1966); *Goodwin* v. *Castleton,* 19 Wash.2d 748, 144 P.2d 725 (1944). See also: *Brody* v. *Chemical Bank,* 517 F.2d 932, 934 (2d Cir. 1975), discussed in the first opinion of the District Court below (404 F.Supp. at 1178).

The plain fact is that Rule 23.1 cannot alter the substantive powers of corporate directors. See 28 U.S.C. § 2072 (1978). Here, there was a change in the personnel on the board after plaintiffs instituted their suit, and Rule 23.1 cannot freeze all action and preclude the corporation from acting in its own best interest. A corporation must be able to evaluate whether it should prosecute the claims raised by a derivative suit in light of circumstances occurring after the suit has been brought, e.g., where there is a

settlement of related litigation, as here, or where there is a settlement of the controversy between the corporations and the defendants in the derivative suit, as occurred in *Wolf* v. *Barkes*, 348 F.2d 994 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965) and *Goodwin* v. *Castleton*, 19 Wash.2d 748, 144 P.2d 725 (1944).

Although many of the decisions upon which plaintiffs rely hold that demand on a corporate board is not required as long as a derivative plaintiff demonstrates in his complaint that a numerical majority of the board is disqualified from passing on the matters at issue, none of those cases involved a lawful delegation of authority to an independent quorum of directors, which quorum became the entire board for purposes of exercising business judgment with respect to the proposed claim. Defendants' position, and that of the parties appearing *amicus*, is that it is wrong for a federal court to ignore that delegation and the good faith exercise of business judgment by Fundamental's directors, all of whom were found to be independent of the delegating majority after extensive discovery on that limited issue.*

2. Plaintiffs (and the Court of Appeals) next seek to make much of the fact that the directors who functioned on this matter were a minority of the full board (five of 11 members). This argument ignores the fact that both

* The further argument that Rule 23.1 required notice to the shareholders and a judicial determination that dismissal was fair misconstrues that portion of Rule 23.1. Under Rule 23.1, *voluntary* dismissals require notice to stockholders and court approval after a hearing, but that rule does not govern *involuntary* dismissals as at bar, where there is no risk of collusive settlement. *Wolf* v. *Barkes*, 348 F.2d 994, 995-97 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965); *Marcus* v. *Textile Banking Co.*, 38 F.R.D. 185, 187 (S.D.N.Y. 1965). See also: Simeone, *Procedural Problems of Class Suits*, 60 Mich.L.Rev. 905, 934 (1961-62); Miller, *Problems of Giving Notice in Class Actions*, 58 F.R.D. 313, 331 (1973).

the Fund's certificate of incorporation and Delaware law expressly authorize the board to act through a quorum, which, in this case, was four directors. Neither the Investment Company Act of 1940 nor existing case law prohibits such action by a lawful quorum of the board of directors. Cf. *Sante Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977). Indeed, the right of the board to act through a quorum is central to its ability to function in many situations.*

Plaintiffs suggest (Brief in Opposition, pp. 6-7, n. **) that the minority directors were "subject to great pressure and control by the malefactors who comprise the majority [of the board of directors]" and that (Brief in Opposition, p. 5, n. *) "[t]he tactic adopted to obtain dismissal was carefully planned and orchestrated." These suggestions were shown to be baseless in the proceedings below. See Petition, p. 5, n. *. The independence of the deciding directors was the subject of extensive discovery by plaintiffs following the District Court's first opinion, and was thereafter fully argued and briefed in the District Court. In its

* The propriety of acting through less than a strict numerical majority of the full board of directors is expressly confirmed in the Delaware General Corporation Law, which provides flexible mechanisms for corporate decision making. Section 141(b) of that statute provides for decision by majority vote of a quorum (which itself can consist of less than a numerical majority of the whole board), and Section 144(a) permits a corporate board to act, in certain cases, by majority vote of its disinterested directors even though they constitute less than a quorum. 8 Del. Code §§ 141(b), 144(a) (1974). The latter section is, of course, consistent with analogous principles of the Investment Company Act of 1940. See, *e.g.*, Sections 15(c) and 10 of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-15(c) and 80a-10 (1970), which provide that renewal of the adviser's contract requires a majority vote of the disinterested directors and that only 40% of the fund's directors need be disinterested. See also: Comment, *Duties of the Independent Director in Open End Mutual Funds*, 70 Mich.L.Rev. 696 (1972).

second opinion, the District Court expressly considered and rejected each of plaintiffs' arguments, finding (426 F.Supp. at 849):

> "Plaintiffs have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently."

The Court of Appeals' opinion does not disturb this finding.

3. Plaintiffs next argue (Brief in Opposition, pp. 9-10) that the board's action is tantamount to a ratification of fraudulent or illegal acts by the defendants. The courts have repeatedly rejected that argument, and recognized that

> "The question whether it is good judgment to sue is quite apart from the question of ratification."

S. Solomont & Sons Trust, Inc. v. *New England Theatres Operating Corp.*, 326 Mass. 99, 111, 93 N.E.2d 241, 247 (1950). Accord: *Kessler & Co.* v. *Ensley Co.*, 129 F. 397, 399 (C.C.N.D. Ala. 1904); *Gall* v. *Exxon Corp.*, 418 F.Supp. 508, 518 n.8 (S.D.N.Y. 1976). The District Court also correctly drew that distinction (404 F.Supp. at 1180). In addition, the wrongs involved in the cases cited by plaintiffs involved looting of the corporation or self-dealing by the defendants—no such wrongs are alleged in the instant case which simply involves an investment decision that resulted in a loss instead of a profit.*

* The plaintiffs' argument, moreover, overlooks the numerous other cases where the courts have upheld the power of disinterested directors not to pursue litigation, even though arguably nonratifiable conduct was at issue. See, *e.g.*, *Alleghany Corp.* v. *Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966) (involving fraud claims); *Swanson* v. *Traer*, 249 F.2d 854, 856 (7th Cir. 1957) (involving fraudulent conspiracy); *Goodwin* v. *Castleton*, 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944) (involving fraud claims); *Brody* v. *Chemical Bank*, 517 F.2d 932 (2d Cir. 1975) (involving federal securities acts and fraud claims); *Gall* v. *Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976) (involving illegal payments). Plaintiffs' reliance on *Mayer* v. *Adams*, 37 Del.Ch. 298, 141 A.2d 458 (1958), is misplaced. The only issue presented in *Mayer* was that of necessity for a demand on shareholders; the role of directors in deciding whether to pursue proposed derivative claims was not at issue. Rule 23.1 (and the comparable Delaware Chancery Court Rule 23.1) only requires such shareholder demand "if necessary." This requires examination, under state law, of shareholders' power to ratify alleged fraud. *See* 3B Moore's Federal Practice ¶ 23.1.19, at 23.1-94 (2d ed. 1978). In *Mayer*, the Court suggested that a unanimous shareholder vote could accomplish a ratification (37 Del. Ch. at 302, 141 A.2d at 460); thus, demand on the shareholders in *Mayer* would have been a futile gesture because the derivative plaintiffs would have voted against ratification. Moreover, the Court clearly recognized that a shareholders' meeting was "not an appropriate forum" for deciding the "probable merits of a minority stockholder's suit" because it would be difficult in all but the simplest cases to have "a reasonably complete presentation and consideration of evidentiary facts." 37 Del. Ch. at 303, 141 A.2d at 461. In the case at bar, of course, the merits of the proposed case were exhaustively considered in a series of directors' meetings, as is customary with respect to important corporate litigation, and by distinguished independent counsel, former Chief Judge Fuld.

Reply to Plaintiffs' Point II

1. Plaintiffs attempt (Brief in Opposition, p. 12) to avoid the conflict between the Court of Appeals' opinion at bar and *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 266-67 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) by referring to other decisions in the Second Circuit which have cited *Kauffman*. Those decisions, however, cited portions of *Kauffman* not at issue here. The matter at issue here is the business judgment rule, not the necessity of pleading the futility of demand on the directors.

2. Plaintiffs next argue (Brief in Opposition, pp. 14-15) that:

> "The question which the Court of Appeals focused upon in the present case was whether the Investment Company Act conferred special power on minority independent mutual fund directors so

as to permit them to abort a derivative action in a situation where directors of other kinds of business corporations could not do so."

This erroneous formulation of the question stands the matter on its head. Congress provided for mutual funds to be organized under state law. Hence, consistent with this Court's holding in *Sante Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977), the pertinent inquiry is not whether the Investment Company Act of 1940 expressly authorizes the board's action, but rather whether it expressly prohibits that which Delaware law permits regarding the internal management of the Fund. Neither plaintiffs nor the Court of Appeals could point to any express provision of the Investment Company Act of 1940 prohibiting the directors from exercising their business judgment as they did.

3. Plaintiffs next urge (Brief in Opposition, p. 16) that the opinion of the Court of Appeals does not "[impute] into the provisions of Section 36(a) [of the Investment Company Act of 1940] the broader provisions of Section 36(b). . . ." This is plainly wrong. The imposition of the separate standards of Section 36(b) upon those of Section 36(a) was central to the decision of the Court of Appeals. Thus the Court of Appeals wrote (567 F.2d at 1212):

> "It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from continuing such litigation [under Section 36(a)], while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter [under Section 36(b)]."

The Court of Appeals was in error in this reasoning. As shown in the Petition (pp. 17-21), such an implication of statutory intent is contrary to the pertinent legislative history and the rationale of Sections 36(a) and 36(b). The District Court correctly recognized the important distinction between those sections (Petition, p. 12a; see also 404 F.Supp at 1179-80).

4. Plaintiffs also incorrectly emphasize (Brief in Opposition, p. 18) the allegedly "nonfrivolous" nature of their action. The decisions of this Court dealing with the business judgment rule and its application to the question whether a corporation should pursue litigation specifically recognize and confirm the right of the board of directors to forego prosecution even of legally meritorious or valid claims. See, *e.g., Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903):

> "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right."

As detailed in the District Court's first opinion (404 F.Supp. at 1176-77), the Fund directors considered and relied upon many such factors in determining that it would be contrary to the best interests of the Fund to pursue the claims plaintiffs would now have them assert. Moreover, contrary to plaintiffs' contentions regarding the alleged merit of their claims, Judge Fuld, independent special counsel, concluded (see 404 F.Supp. at 1176):

> "As a result of my analysis of the facts and the law, it is my opinion that there was no violation by

> Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

The District Court, in its second opinion, which followed extensive discovery by plaintiffs, also rejected the claim that the independent directors were not truly "independent" based upon the manner in which they were selected and the fact that they received compensation for serving as directors (see 426 F.Supp. at 849 and 850).

5. Finally, plaintiffs argue (Brief in Opposition, p. 19) that the procedure followed by the disinterested directors at bar renders Rule 23.1 "meaningless." Rule 23.1 complements the business judgment rule by assuring that, absent certain unusual circumstances, every corporate board of directors will be permitted to decide whether or not to pursue litigation for the corporation's benefit. This, defendants submit, is why the so-called "demand" cases are supporting authority for their position at bar. Plaintiffs' position reduces to a claim that the delegation of board authority to and decision by a quorum consisting of Fundamental's independent directors was null and void. But the delegation of the authority to decide and the decision itself were accomplished within the framework of state law, and plaintiffs have cited no case condemning such an approach. The fact that it may be a new approach does not mean that it is in any way improper as a matter of law or sound policy.

The District Court recognized that Fundamental's actions were consistent both with the law of its home state and with the general state and federal policy favoring resolution of questions of corporate management within

the corporate structure. Moreover, the District Court gave plaintiffs every opportunity to explore the question of the independence of the deciding directors, thus obviating any suggestion of unfairness in the result. By its reversal, the Court of Appeals has seriously undermined the business judgment rule in the context of derivative actions involving mutual funds.

CONCLUSION

A writ of certiorari should issue to the United States Court of Appeals for the Second Circuit.

Respectfully submitted,

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PETITIONERS' BRIEF

Opinions Below

The opinions of the District Court (Werker, *J.*) are reported at 404 F.Supp. 1172 (S.D.N.Y. 1975) and at 426 F.Supp. 844 (S.D.N.Y. 1977). The District Court also filed an unreported opinion and order denying a motion for reargument on January 7, 1976. The opinion of the Court of Appeals is reported at 567 F.2d 1208 (2d Cir. 1978). All four opinions below are reproduced in the Appendix in this Court (A. 5-48).

Jurisdiction

The judgment of the Court of Appeals was entered on January 11, 1978, and a timely petition for rehearing was denied on March 9, 1978. A petition for writ of certiorari was filed on June 2, 1978 and granted on October 2, 1978. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

Statutes Involved

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. § 80a-1 *et seq.* and the Delaware Corporation Law, Del Code tit. 8, § 101 *et seq.* The pertinent provisions of those statutes are set forth, with an index thereto, in Addendum A at the back of this brief.

Question Presented

Plaintiffs*, two out of 90,000 shareholders of a $1 billion mutual fund incorporated under the laws of the State of Delaware, seek—by means of a derivative action—to compel the fund to sue its investment adviser and various directors of the fund to recover from them an investment loss sustained by the fund in the regular course of its business.

Three years prior to the filing of the derivative action, the fund had initiated litigation against the seller of the commercial paper notes which were the subject of the investment loss. One year subsequent to the filing of the derivative action, the fund entered into a settlement with the seller of the notes, pursuant to which the fund received a multi-million dollar recovery.

The disinterested directors of the fund, who are not defendants in the derivative action and who constitute a quorum of the board of directors, then considered the claims raised in the derivative action. After an in-depth study of the matter, with the aid of independent special counsel, they unanimously concluded, in the exercise of their business judgment, that maintenance of the derivative action was contrary to the best interests of the fund and its shareholders. The disinterested directors thereupon instructed the fund's litigation counsel to move to dismiss the derivative action.

* In this brief respondents are referred to as "plaintiffs" and petitioners as "defendants".

The District Court held, in its first opinion, that the disinterested directors had the power, as a matter of business judgment, to determine on behalf of the fund that the claims asserted in the derivative action should not be prosecuted and that the derivative action should be dismissed. After permitting extensive discovery on the issue of the independence of the disinterested directors, the District Court held, in its second opinion, that they were truly disinterested and independent, and had exercised their business judgment in good faith. Accordingly, the District Court granted the renewed motion to dismiss.

The Court of Appeals, while agreeing that the disinterested directors had acted in good faith, held that they had no power to terminate the derivative action. The Court of Appeals concluded that the Investment Company Act of 1940 impliedly precluded the disinterested directors from exercising their business judgment to forego prosecution of the claim against the investment adviser and the other directors. On this basis, the Court of Appeals reversed and remanded.

QUESTION: Are the disinterested directors of a mutual fund, who constitute a quorum and have been found to be truly disinterested and independent, incapacitated *as a matter of law* from exercising their business judgment to determine whether maintenance of a stockholders' derivative action against the investment adviser and various directors of the fund, to recover from them an investment loss sustained by the fund, is in the best interests of the fund and its shareholders: i.e., does the Investment Company Act of 1940 require that a stockholders' derivative action be permitted to proceed, in any and all events, even though the disinterested directors have concluded, in the good faith exercise of their business judgment, that maintenance of the derivative action is contrary to the best interests of the fund and its shareholders?

Statement of the Case

This case involves a fundamental issue of corporate governance, raised in the specific context of a mutual fund corporation, to wit: do the disinterested directors of such a corporation—assuming they are independent, informed and acting in good faith—have the responsibility and authority to run the affairs of the corporation, or can a single stockholder, merely by instituting a derivative action, seize the reins of the corporation, render nugatory a sound and well-reasoned exercise of business judgment by the directors, and *compel* the corporation to assert a claim in litigation, the maintenance of which the directors have determined to be contrary to the best interests of the corporation and its shareholders? The underlying transaction in this case did not involve self-dealing of any kind by the investment adviser or the directors, but merely an investment loss sustained in the regular course of business. To preclude disinterested directors from exercising business judgment in such circumstances will undermine the important principle that it is the directors who have the responsibility *and* power to direct the affairs of corporations. The result will be to put the judiciary into the board room.

The facts of this case, as found by the District Court, are not in dispute and were not disturbed by the Court of Appeals, which based its decision on a matter of law.

Fundamental Investors, Inc. ("Fundamental") is an open-end investment company (commonly known as a "mutual fund") incorporated under the laws of the State of Delaware and registered under the Investment Company Act of 1940 (A. 65). Anchor Corporation ("Anchor"), and its predecessor companies, have been the investment adviser to Fundamental for over 45 years.

The purchase of Penn Central commercial paper and its aftermath—1969

On November 26, 1969, Fundamental purchased $20 million of the commercial paper (270-day notes) of Penn Central Transportation Company ("Penn Central") from Goldman, Sachs & Co., a leading commercial paper dealer (A. 66). At the time of the purchase, Penn Central commercial paper was rated "Prime" by the National Credit Office, a subsidiary of Dun & Bradstreet, Inc., the most widely utilized commercial paper rating agency in the country (A.95).* Fundamental had a portfolio with a net asset value of approximately $1 billion (A. 66). The purchase of Penn Central commercial paper was a transaction undertaken in the regular course of business by Fundamental, which purchased commercial paper periodically throughout the year as a short-term utilization of funds until they were needed for purchases of portfolio securities in the stock market or for redemption of Fundamental's own shares (A. 82-3). Commercial paper of major national corporations like Penn Central was widely considered by the financial community to be a cash equivalent, the safety of which was not in question (A. 78, 132).

On June 21, 1970, Penn Central, the sixth largest corporation in the country, with assets of over $6 billion, filed a Petition for Reorganization (A. 66). The notes purchased by Fundamental (and many other renowned financial institutions, universities, charitable organizations, etc., most of which purchased their notes *after* the purchase by Fundamental) were not paid at maturity (A. 128-130).

* In October 1969, one month before the purchase by Fundamental, the Interstate Commerce Commission had authorized Penn Central to increase its outstanding commercial paper to $200 million from $150 million, and had assessed it as ". . . in a strong financial condition" (A. 132).

The *Welch* action—1970

On November 4, 1970, following consideration of the matter by the Board of Directors, Fundamental initiated an action, with three other plaintiffs, against Goldman, Sachs & Co. ("the *Welch* action") under the federal securities laws for rescission of their purchases of the notes (A. 66). The Complaint charged that Goldman, Sachs & Co., the exclusive dealer in Penn Central commercial paper, had withheld material, adverse non-public information on the financial condition of Penn Central (A. 87). Within a year, approximately 35 such suits had been commenced against Goldman, Sachs & Co. by other purchasers of the notes (See MDL 56A—*In re Penn Central Securities Litigation,* 325 F.Supp. 309 (J.P.M.D.L. 1971)).*

The *Lasker* action—1973

On February 5, 1973, more than three years after the purchase by Fundamental, two stockholders of Fundamental commenced the instant derivative action ("the *Lasker* action") purportedly on behalf of Fundamental (A. 67). The Complaint named as defendants Anchor and all of the persons who were directors of Fundamental at the time of the purchase (i.e., 1969), and charged them with violation of statutory and common law duties in making and retaining the investment for Fundamental in Penn Central commercial paper (A. 49-63).

On July 30, 1973, on motion of all defendants, and prior to joinder of issue, then District Judge Murray I. Gurfein stayed the *Lasker* action pending the resolution of the claims of Fundamental against Goldman, Sachs & Co. in the *Welch* action (A. 67).

On July 9, 1974, on the eve of the trial of the *Welch* action, Fundamental entered into a favorable settlement as

* Of these, four were tried and the rest were settled.

follows: Goldman, Sachs & Co. took back the notes, paid Fundamental $5.25 million in cash and, for the balance of the claim, assigned to Fundamental a 73.75 per cent interest in the proceeds of the $20 million of notes in the Penn Central reorganization proceedings (A. 67).*

The disinterested quorum

On July 24, 1974, at their next regular meeting, the Board of Directors of Fundamental reviewed the status of the *Lasker* action, and determined that the five directors who (a) were not affiliated in any way with Anchor, and (b) were not directors at the time of the events complained of in the *Lasker* action, and (c) were not defendants in the *Lasker* action, would, acting as a quorum pursuant to the by-laws and Delaware law, constitute the Board of Directors to decide what position Fundamental should take regarding the *Lasker* action. The Board of Directors determined that the six other directors, i.e., the four who were affiliated with Anchor and the two who were not affiliated with Anchor but who were named as defendants in the *Lasker* action, would take no part in the decision (A. 69-70).

The five disinterested directors are persons with distinguished careers in business and government** (A. 70):

* A plan of reorganization was approved this year, and the notes have substantial value in the form of stock and certificates of beneficial interest in the reorganized company.

** Plaintiffs, in the proceedings below, challenged the independence of the disinterested directors, suggesting that they had been selected by the defendants for the purpose of aborting the *Lasker* action. The charge is baseless and was rejected by the District Court. The disinterested directors were suggested for nomination by the Directors' Qualification Committee, of which, at all times, a majority (two of three) consisted of disinterested directors (A. 143, 163). Furthermore, two of the five directors who made up the disinterested quorum

Leon T. Kendall is a professional economist and the President of Mortgage Guaranty Insurance Corporation of Milwaukee, Wisconsin. He had been a member of the faculty of the School of Business, Indiana University, an economist for the Federal Reserve Bank, Atlanta, an economist for the New York Stock Exchange, President of the Association of Stock Exchange Firms, and, finally, President of the Securities Industry Association (A. 70);

Dr. Beryl Robichaud is a Senior Vice President of McGraw Hill, Inc. She is also a director of Aetna Life & Casualty Corporation, and the author of two books in the field of business management (A. 70);

William J. Stephens is the retired Chairman of the Board and Chief Executive of Jones & Laughlin Steel Company. He was also a director of several other major corporations (A. 70);

Louis F. Laun was the Deputy Administrator of the Small Business Administration, Washington, D.C. and also had a long career in private industry prior to his government service (A. 70);

Mary S. O'Connor is a director and member of the Executive and Trust Committees of the Central Home Trust Company of Elizabeth, New Jersey. She was also one of the first women officers of International Business Machines Corporation (A. 70).

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that acted as the Board in this case became directors before there even was a *Lasker* action. Laun became a director in 1971 (A. 70) and O'Connor in 1972 (A. 70). The *Lasker* action was not filed until 1973. None of the five disinterested directors had any business or professional relationships with any of the defendants (A. 147-50 and transcripts of testimony; see also Section 2(a)(19) of the Investment Company Act of 1940), and their social relationships with the defendants were non-existent or *de minimis,* as the District Court found (A.28).

To assist them in their consideration of the matter, the disinterested directors decided to retain independent special counsel. They reviewed several possible choices and then selected Hon. Stanley H. Fuld, former Chief Judge of the State of New York (A. 71). Judge Fuld had no previous connection with any of the parties (A. 138).

Judge Fuld, over the course of the next several months, reviewed and analyzed the Complaint in the *Lasker* action and the documents and depositions in the *Welch* action (A.82). He also reviewed the files of Fundamental and Anchor relating to the purchase of the Penn Central commercial paper, and interviewed the officers of Fundamental and Anchor who had knowledge of the relevant events (A. 82). In addition, he reviewed the corporate documents of Fundamental and the applicable statutes, regulations and case law (A.82).

The Fuld Report

On December 5, 1974, Judge Fuld reported the results of his analysis in a comprehensive legal and factual memorandum (A. 81-111). His conclusion was (A. 82):

> "As a result of my analysis of the facts and the law, *it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund,* in connection with the acquisition and retention of the Penn Central commercial paper." (emphasis supplied)

Judge Fuld also identified and analyzed the alternative courses of action available to the directors, and concluded his memorandum as follows (A. 111):

> "It is for the Board of Directors of the Fund to determine, in the exercise of its discretion and business judgment, which alternative to adopt."

After receiving and reviewing Judge Fuld's December 5, 1974 memorandum, the disinterested directors raised several questions regarding the subjects covered in the memorandum and the alternatives available to them. (A. 72).

In response to these questions raised by the disinterested directors, on December 18, 1974, Judge Fuld delivered a brief supplemental memorandum in which he advised, among other things, that whether or not a corporation should seek to enforce in the courts a cause of action for damages is, like other business questions, a matter of internal management and, accordingly, a matter for the business judgment of the directors (A. 72, 112-116).

The meeting of December 18, 1974

On December 18, 1974, the disinterested directors held a special meeting devoted exclusively to this subject (A. 72). At the meeting they discussed the entire matter with Judge Fuld at length (A. 73). They sought and received Judge Fuld's views as to (a) the merits of each of the claims asserted in the *Lasker* action, (b) whether Anchor had followed proper procedures, (c) the standards they should apply in determining their course of action, and (d) the alternative courses of action available to the Board of Directors (A. 73-74). They also questioned management about the facts and circumstances of the underlying transaction, the procedures followed, the nature of the commercial paper market and the likely effects to be anticipated from the different alternative courses of action (A. 74-75). The subjects covered are set forth in detail in the minutes of December 18, 1974 (A. 117-127). After several hours of discussion, they adjourned the meeting and decided to give the matter further thought before reaching a decision (A. 75).

During late December 1974 and early January 1975, Mr. Kendall, as the chairman of the disinterested quorum, spoke by telephone* with each of the four other disinterested directors, and gathered the further questions they wanted answered. Indicative of the thoughtful consideration the directors were giving to the matter is the letter written to each of his fellow directors by Mr. Stephens on December 31, 1974, a copy of which is reproduced in Addendum B at the back of this brief.

During the first week of January, 1975, Mr. Kendall conferred with Judge Fuld by telephone and reviewed the questions that he had gathered from the other disinterested directors (A. 76).

The meeting of January 6, 1975

On January 6, 1975, the disinterested directors held another special meeting of the Board of Directors (A. 76). No defendant and no one from Anchor was present (A. 137). After several hours of review and deliberation, the disinterested directors voted unanimously to instruct the fund's litigation counsel to move to dismiss the *Lasker* action as contrary to the best interests of Fundamental (A. 79). The subjects covered are set forth in detail in the minutes of January 6, 1975 (A. 137-141). The factors considered by the disinterested directors in their decision to seek dismissal of this action were summarized by Mr. Kendall as follows (A. 77-79):

> "(a) Chief Judge Fuld's opinion that there is no merit to the action and little likelihood of its success;

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* The five were widely scattered geographically (A. 163): Mr. Kendall lived in Wisconsin; Mr. Stephens lived in South Carolina Mr. Laun lived in Washington, D.C.; Dr. Robichaud and Mrs. O'Connor lived in different parts of New Jersey.

"(b) The business interruption to Anchor, distraction of its personnel and the likely inability for it to attract and maintain personnel during pendency of the action necessarily would be harmful to the shareholders of Fundamental;

"(c) If the action were to proceed against Anchor with the acquiescence or under the control of Fundamental, the adversary relationship that would be created between Fundamental and Anchor and the attendant serious distraction of Anchor's personnel from their efforts on behalf of the shareholders of Fundamental would leave us no practical alternative but to remove Anchor as investment adviser and to seek to retain a new investment adviser; this would necessarily result in delay, uncertainty and an inevitable lapse in the management of Fundamental's affairs to the serious detriment of its shareholders;

"(d) Anchor had acted in good faith and in what it believed was in the best interests of Fundamental's shareholders in purchasing the Penn Central commercial paper;

"(e) Anchor had acted reasonably and had followed procedures prudent at the time in light of the then generally held belief that commercial paper was equivalent to cash;

"(f) A vast number of other institutional investors, including many major banks in New York City and throughout the country and certain major mutual funds, had also believed that Penn Central was a sound business enterprise and had purchased Penn Central commercial paper at the time, and many such investors still held that paper when Penn Central petitioned for reorganization;

"(g) To take no position at all and thereby allow two of the more than 90,000 shareholders to determine the course of this action would not be a decision at all, but an avoidance of our obligation to all the shareholders;

"(h) Chief Judge Fuld's advice that an investment adviser is not a guarantor of the investments it makes and can only be charged for breaches of contract or of the standards applied by the pertinent statutes and regulations. Chief Judge Fuld had analyzed the facts and law and had concluded that Anchor was not at fault and that there was little likelihood that Anchor would be held to have violated any statute or regulation or to have breached any agreement or duty;

"(i) Given Chief Judge Fuld's opinion, if the action were to proceed, there could be unnecessary costs to the shareholders of Fundamental for legal fees, both for its own counsel and for the director defendants, who would be entitled to reimbursement of counsel fees if they were found to be not liable to Fundamental; and

"(j) Even if there were a recovery of the theoretical maximum amount of damages, the net result to the shareholders of Fundamental would be little more than a net recovery of 10 cents per share, or approximately 2% of Fundamental's net asset value. The remote chance of recovering that small amount was not worth the risk of the serious damage to Fundamental's shareholders which proceeding with this action might produce."

The first District Court opinion — 1975

The District Court, in its first opinion, endorsed the basic theory of the motion to dismiss, i.e., that the disinterested directors had the power, in the exercise of their business judgment, to determine that the possible corporate claim should not be prosecuted (A. 5-20). The District Court held (A. 16):

> "In the Court's view, the independent minority of directors had the power to decide what position the Fund should take. This is consistent with the policy that a corporation be given the opportunity to control a lawsuit brought on its behalf, that the Board be allowed to exercise its normal functions in running the corporation, and that a derivative suit should be resorted to as a last alternative. [citations omitted]"

Pursuant to the rule of *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917) as set forth by this Court (discussed in Point I, *infra*, pp. 20-25) the District Court held (A. 17):

> ". . . the decision whether or not to sue is a matter of internal management. [citation omitted] Absent fraud or corruption or other factors, the stockholders cannot force the corporation to sue."

The District Court expressly dealt with and rejected each argument raised by plaintiffs, including the argument later relied on by the Court of Appeals, i.e., that the Board had no *power* to exercise its business judgment because of the public policy embodied the Investment Company Act of 1940 (A. 18). In rejecting this argument, the District Court reasoned that the directors of the fund should be given the chance to perform their duties with respect to management of the fund's affairs, including whether or not

a possible claim of the fund should be prosecuted in the courts. The District Court held (A. 19):

> "If they [the directors] have exercised their business judgment in good faith then a decision not to sue should be final."

To assure total fairness, the District Court then gave plaintiffs the right to conduct discovery on the issue of whether the disinterested directors were truly disinterested and independent, and denied the motion to dismiss with leave to renew after discovery (A. 20).

The discovery proceedings — 1976

Thereafter, plaintiffs conducted lengthy examinations of all five of the disinterested directors, and of John R. Haire, the Chairman of Anchor. In addition, plaintiffs requested and received two extensive document productions (A. 145-150).

The transcripts of the testimony, which are part of the record in this Court, demonstrate abundantly, as the District Court found (A. 28), that the five directors were truly disinterested and acted with complete independence of all defendants in the *Lasker* action.

The testimony showed that none of the five disinterested directors is related to any of the defendants by blood or marriage; none knew more than one or two of the 11 directors at the time they joined the Board (A. 165-69); none had any personal stake in the outcome of their deliberations (A. 147-50 and transcripts of testimony).

Furthermore, each of the five disinterested directors testified that neither he nor she had any contact whatsoever with Mr. Haire or anyone else from Anchor at any time during the period they were studying and deliberating this matter, nor had anyone from Anchor ever attempted to influence their deliberations in any way. See testimony of

O'Connor (Tr. 83-87); Robichaud (Tr. 120-125); Stephens (Tr. 130-137); Laun (Tr. 148-152); and Kendall (Tr. 217-226). The testimony of Mr. Haire is to the same effect: *"I totally isolated myself from the whole proceeding"* (Tr. 270). (emphasis supplied)

The second District Court opinion — 1977

At the conclusion of the discovery proceedings, pursuant to leave granted in the opinion on the original motion to dismiss, Fundamental, joined by all other defendants, renewed its motion to dismiss.

The District Court, in its second opinion, reviewed all of the evidence and all of the arguments raised by plaintiffs and held (A. 28):

> "Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently." (emphasis supplied)

The District Court further stated that, in its judgment, the burden of proof was on plaintiffs to establish that the minority directors lacked independence, and that "[t]he unsupported contentions of the plaintiffs clearly fail to meet this burden . . ." (A. 36). The District Court then stated (A. 36-37):

> "I hasten to add, however, that even if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims raised in this suit they have done so. The exhibits presented to the court on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit."

The District Court thereupon granted the renewed motion to dismiss (A. 38).

The Court of Appeals opinion — 1978

On January 11, 1978, the Court of Appeals reversed and remanded, holding that, *as a matter of law*, the Investment Company Act of 1940 impliedly deprived the disinterested directors of their power to determine whether or not a claim should be prosecuted against the investment adviser and various fund directors for an investment loss sustained by the fund (A. 39-48).

The Court of Appeals expressly acknowledged (A. 48):

> "We have no doubt that the five minority directors acted in good faith in all that they did."

Notwithstanding this conclusion, the Court of Appeals held that the stockholders' derivative action must be permitted to proceed to a trial on the merits, irrespective of the good faith business judgment by the disinterested directors that maintenance of the claim was contrary to the best interests of the fund.

A timely petition for rehearing with a suggestion of rehearing *in banc* was denied on March 9, 1978 (A. 170-171).

Summary of Argument

The Court of Appeals erroneously concluded that, *as a matter of law*, disinterested directors of a mutual fund cannot be trusted to reach a sound and honest business

judgment even when the District Court finds, as a matter of fact, that this is precisely what they have done—this result is an unreasoning indictment of an entire class of people, does violence to the statutory framework of the Investment Company Act of 1940 and is at variance with the legislative history and the relevant case law.

The central error of the opinion of the Court of Appeals is found in the following three sentences (A. 47):

> "[1] It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned. [2] Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. [3] *It follows that disinterested directors of an investment company do not have the power* to foreclose the continuation of non-frivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties." (emphasis and numbering supplied)

The first two sentences quoted above reflect merely the subjective attitudes of the Court of Appeals—there is no support in the record for these views. The third sentence, which is the central holding of the Court of Appeals in this case, is a complete non-sequitur, having nothing to do with and not logically, legally, or factually flowing from

the two preceding sentences. The point is simply this: whether or not the directors have the *power* to do an act must be determined by reference to applicable law—it surely cannot flow from "human nature" and what "the public . . . would believe" as those two are perceived by the Court of Appeals. The opinion of the Court of Appeals, in this respect, is without basis in law.

The principal rationale set forth by the Court of Appeals for ignoring the long-standing business judgment rule was the allegedly "unique nature" of mutual fund corporations. However, there is nothing in the Investment Company Act of 1940 which expressly or impliedly supports this departure from the general rule. Indeed, to the contrary, relevant case law construing the powers of disinterested directors, as well as the legislative history and the structure of the Investment Company Act of 1940 itself, make clear that the disinterested directors do have power to exercise business judgment, even in matters involving possible conflict with the adviser. The effort by the Court of Appeals to bolster its conclusion by reading the unique provisions for review of directors' decisions found in Section 36(b) into Section 36(a), which contains no such provisions, is unfounded both as a matter of statutory construction and legislative history.

In addition, the decision of the Court of Appeals is in conflict with the principles of *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977) and *Cort* v. *Ash,* 422 U.S. 66 (1975) since there is no federal statutory provision which expressly supersedes the powers of the disinterested directors under Delaware law.

POINT I

The decision to prosecute or terminate litigation brought on behalf of a corporation is a matter for the business judgment of the disinterested directors of the corporation.

In a line of cases going back more than 75 years, this Court has held that the decision whether or not to prosecute litigation on behalf of a corporation rests solely with the board of directors. Absent fraud, corruption, or similar invalidating factors, a board's exercise of business judgment that a claim should not be prosecuted is final, and a stockholder's derivative action asserting that claim may not be maintained. See, e.g., *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455 (1903).

In *Corbus, supra,* this Court set forth the business judgment rule in the context of a litigation decision as follows (187 U.S. at 463):

> "The directors represent all the stockholders, and are presumed to act honestly and according to their best judgment for the interests of all.* Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon

* The Court of Appeals, in the case at bar, erroneously based its decision on precisely the opposite presumption.

> the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors of the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs."

This doctrine was subsequently reaffirmed by this Court in *United Copper, supra* (244 U.S. 261). In that case, the plaintiff stockholder claimed that his corporation had been damaged by the defendants' actions in violation of the anti-trust laws. The board considered suing the defendants and refused to do so. This Court ruled that the stockholder could not then maintain a derivative action on behalf of the corporation. Justice Brandeis wrote (244 U.S. at 263):

> "Whether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management, and is left to the discretion of the directors, in the absence of instruction by vote of the stockholders."

The federal Courts of Appeals in more recent cases have also adhered to this rule. See, e.g., *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 274-5 (3d Cir. 1978); *Ash* v. *IBM*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied,* 384 U.S. 927 (1966); *Swanson* v. *Traer*, 249 F.2d 854, 859 (7th Cir. 1957).

In *Swanson* v. *Traer, supra* (249 F.2d 854), the plaintiff shareholder claimed that his corporation had been defrauded in its purchase of certain properties. He asked the

board to sue the alleged wrongdoers and the board refused. The Court of Appeals for the Seventh Circuit barred a derivative suit by the shareholder, holding (249 F.2d at 859):

> "A corporation's right not to sue is correlative to its right to sue. Unless an equitable basis for intervention be shown, an individual stockholder has no more right to challenge by a derivative suit a decision by the board of directors not to sue than to so challenge any other decision by the board."

In *Ash* v. *IBM, supra* (353 F.2d 491), a shareholder of three publishing corporations asserted that IBM's acquisition of another publisher violated the antitrust laws to the damage of his corporations. He requested the boards of directors of his corporations to sue IBM under the antitrust laws, but the boards refused. The Court of Appeals for the Third Circuit affirmed the dismissal of a derivative suit by the shareholder, stating (353 F.2d at 493):

> "The Supreme Court and, following it, the Courts of Appeals have repeatedly stated and applied the doctrine that a stockholder's derivative action, whether involving corporate refusal to bring antitrust suits or some other controversial decision concerning the conduct of corporate affairs, can be maintained only if the stockholder shall allege and prove that the directors of the corporation are personally involved or interested in the alleged wrongdoing in a way calculated to impair their exercise of business judgment on behalf of the corporation, or that their refusal to sue reflects bad faith or breach of trust in some other way. [citations omitted] Prevailing doctrine in the state courts is to the same effect. [citation omitted]"

In *Cramer, supra* (582 F.2d 259), the Court of Appeals for the Third Circuit affirmed the dismissal of a

derivative action on the basis of plaintiff's failure to make demand on the board of directors. In that case, a committee of independent members of the board of directors of the corporation had determined that, as a matter of business judgment, prosecution of the claim would be contrary to the best interests of the corporation. Although this exercise of business judgment was not the basis of the District Court's dismissal, the Court of Appeals analyzed the issue in depth and wrote (582 F.2d at 275):

> "Important policies underlie both the demand requirement and the business judgment rule as a bar to shareholders' derivative actions. The demand requirement enables corporate management to pursue alternative remedies, thus often ending unnecessary litigation. Moreover, deference to the directors' judgment might terminate meritless causes of actions and prevent the corporation from incurring the costs of participating in derivative suits. Even if a particular suit has some merit, the litigation costs and the adverse effect on the business relationship between the corporation and the potential defendant might outweigh any potential recovery in the lawsuit.* Finally, derivative actions could be brought not to remedy wrongs to the corporation, but to induce settlements beneficial to the named plaintiff or his counsel. [citation omitted]"

* This correct and practical analysis shows the fallacy of the distinction drawn by the Court of Appeals in the case at bar between "frivolous" and "non-frivolous" litigation (see A. 39, 40, 43 and 47). The merit, if any, of the underlying claim is merely one of many factors to be considered by the directors in the exercise of their business judgment. See also *Corbus, supra* (187 U.S. at 463). In this case, the merits of the underlying claims were the subject of detailed analysis by independent special counsel, who concluded they were without merit (A.82), and careful review and consideration by the disinterested directors (see e.g. A. 73-4, 120), as the District Court found (A. 36).

The Court in *Cramer, supra* (582 F.2d 259) also expressed the view that the business judgment of directors should not be *totally* insulated from judicial review, but that "to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing." (582 F.2d at 275). The Court added that "where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should . . . be able to conduct its own analysis of the reasonableness of that business judgment." (582 F.2d at 275).

In the case at bar, plaintiffs have not argued and could not effectively argue that the disinterested directors' judgment was "so unreasonable as to fall outside the permissible bounds of the directors' sound discretion." Thus, under the approach of the Court in *Cramer, supra* (582 F.2d 259), the business judgment of the disinterested directors in this case clearly merits judicial deference.

The issue raised in this case has also been recently addressed by three different district judges of the United States District Court for the Southern District of New York; all three have sustained the right of the directors, in the exercise of their business judgment, to forego or terminate litigation. *Gall* v. *Exxon Corp.*, 418 F.Supp. 508 (S.D.N.Y. 1976); *Lasker* v. *Burks*, 404 F.Supp. 1172 (S.D.N.Y. 1975); *Bernstein* v. *Mediobanca Banca di Credito*, 69 F.R.D. 592 (S.D.N.Y. 1974).

The state courts, as noted in *Ash, supra* (353 F.2d 491), also follow the rule that a valid business judgment of a corporation's board of directors—including whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit. See, e.g., *Goodwin* v. *Castleton*, 19 Wash. 2d 748, 764, 144 P.2d 725, 733 (1944); *Findley* v. *Garrett*, 109 Cal App

2d 166, 178, 240 P.2d 421, 431 (Dist. Ct. App. 1952); *Beard* v. *Elster*, 39 Del.Ch. 153, 165, 160 A.2d 731, 738-9 (1960); *Puma* v. *Marriott*, 283 A.2d 693, 696 (Del.Ch. 1971); *McKee* v. *Rogers*, 18 Del.Ch. 81, 85-6, 156 A. 191, 193 (Ch. 1931).

For example, in *Goodwin, supra* (19 Wash.2d 748, 144 P.2d 725), minority shareholders had commenced a derivative action against certain members of the board of their corporation, charging wrongful self-dealing and waste of corporate assets. After the suit had been pending for a few years, the then board of directors settled the corporate claim with the defendants. Noting that the board of directors had found, in its view, that there had been no wrongful conduct by defendants and that the suit had no merit (19 Wash.2d at 757-8, 144 P.2d at 730), the Court dismissed the action, stating (19 Wash.2d at 764, 144 P.2d at 733):

> "Since those who conduct the affairs of the corporation or who have the ultimate power of control over it have the right, in the first instance, to determine whether a suit shall be brought by the corporation or whether an existing controversy shall be compromised without suit, so they also have the right to inquire, consider, and determine whether a suit already brought by a dissentient stockholder is well-founded, what its chances for success may be, and whether in any event its continued maintenance may injuriously affect the present or future prosperity of the corporation."*

As a matter of elementary logic, the case at bar falls squarely within this legal principle.

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* Plaintiffs have argued previously that since demand under Rule 23.1, Fed. R. Civ. P. was allegedly excused, the quorum of independent directors had no power to terminate this action. Accordingly, plaintiffs state (Brief in Opposition to Certiorari, p. 6):

> "Obviously, if the minority cannot prevent commencement, it similarly cannot cause termination."

No case so holds, and several decisions contradict that conclusion. See, e.g., *Wolf* v. *Barkes*, 348 F.2d 994, 997 (2d Cir.), *cert.*

POINT II

The Court of Appeals erred in holding that the Investment Company Act of 1940 precluded the disinterested directors from exercising their business judgment to terminate this litigation.

In disregarding the long-standing legal principle set forth in Point I, the Court of Appeals wrote (A. 48 n. 14):

> "We base our decision on the unique nature of the investment company and its symbiotic relationship with its investment adviser; we need not reach questions of the exercise of similar power by directors of other types of corporations."

The notion that mutual fund directors—especially the disinterested directors—are under a special disability in regard to exercising business judgment is not borne out by the provisions of the Investment Company Act of 1940, the legislative history of the statute or the relevant case law construing the statute.

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denied, 382 U.S. 941 (1965); *Alleghany Corp.* v. *Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966); *Goodwin* v. *Castleton*, 19 Wash.2d 748, 144 P.2d 725 (1944). See also: *Brody* v. *Chemical Bank*, 517 F.2d 932, 934 (2d Cir. 1975), discussed in the first opinion of the District Court (A. 16).

The plain fact is that Rule 23.1, a rule of procedure, cannot alter or abridge the substantive powers of corporate directors, including their business judgment powers. See 28 U.S.C. § 2072 (1978) and *U.S.* v. *Sherwood*, 312 U.S. 584, 590 (1941); *Brennan* v. *Silvergate Dist. Lodge No. 50*, 503 F.2d 800, 804 (9th Cir. 1974). If Rule 23.1 were interpreted as plaintiffs would have it, the board's posture would be frozen as of a single instant in time, and the directors would be prevented from acting in the best interests of the corporation and its shareholders in light of evolving circumstances. The responsibility of a board of directors to exercise business judgment is a continuing responsibility and the directors must have the power to fulfill that continuing responsibility.

The Court of Appeals did not, and could not, point to any express provision of the Investment Company Act of 1940 which precludes the directors from exercising their business judgment as they did in this case—there is no such provision. Instead, the Court of Appeals held that the Investment Company Act of 1940 *impliedly* prohibited them from exercising their business judgment to determine whether or not the claim asserted in the derivative litigation should be prosecuted. In so doing, the Court of Appeals based its conclusion on two premises—(1) its subjective view of "human nature" and "what the public . . . would believe", discussed at pp. 18-19 *supra*, and (2) a faulty analysis of the interplay of Sections 36(a) and 36(b) of the Investment Company Act of 1940.*

The Court of Appeals reasoned that since Congress, in the 1970 amendments to the Investment Company Act of 1940, "specifically provided in Section 36(b) that shareholders may sue derivatively to recover excessive fees paid to the adviser", it "would surely be anomalous" not to imply the same power for the alleged violations of Section 36(a) sued upon here (A. 45, 46). Why it "would surely be anomalous" is not explained, nor is any authority offered for the proposition.

Section 36(b) was enacted into law by Congress in 1970 as an amendment to the Investment Company Act of 1940 —it is a unique and highly specific section dealing solely with the compensation of investment advisers. Section 36(b) *expressly* created a right of action by a shareholder of a mutual fund against the investment adviser for breach of fiduciary duty with respect to investment advisory fees,

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* Section 36(a) deals with the broad subject of fiduciary duties of investment advisers; Section 36(b), which was added to the statute in the 1970 amendments, deals solely with the subject of compensation of investment advisers.

irrespective of whether the disinterested directors have, in the exercise of their business judgment, approved those fees.

If Congress had intended to provide in Section 36(a), which is a far broader section than Section 36(b), the unique mechanisms of Section 36(b), it could and would have done so in the 1970 amendments—it did not do so. The Court of Appeals improperly added such a provision to Section 36(a) where Congress saw fit not to do so.

The legislative history, which was not cited by the Court of Appeals, supports defendants' view. Thus, Senate Report No. 91-184, 91st Cong., 1st Sess. at 16 (1969), reprinted in 3 U.S. Code Cong. & Ad. News, at 4911 (1970), which accompanied the 1970 amendments, states:

> "Although section 36(b) provides for an equitable action for breach of fiduciary duty as does section 36(a), *the fact that subsection (b) specifically provides for a private right of action should not be read by implication to affect subsection (a).*" (emphasis supplied)

The foregoing passage, although focusing on the existence of a private right of action, a subject not at issue in this case, indicates that Congress did not intend that the new Section 36(b) be read to affect, in any way, Section 36(a). In short, the subject of investment adviser compensation covered by Section 36(b) is *sui generis*.

Moreover, the Senate Report expressly reaffirmed Congress' intent not to disturb the authority of disinterested directors to manage the affairs of a mutual fund in the exercise of their business judgment (*id.* at 7, reprinted in 3 U.S. Code Cong. & Ad. News at 4903 (1970)):

> "These provisions highlight the fact that *the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of the directors.* Indeed, this section is designed to strengthen the ability of the unaffiliated directors to deal with these matters and to provide a means by which the Federal courts can effectively enforce the federally-created fiduciary duty with respect to management compensation [i.e., Section 36(b)]. *The section is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.*" (emphasis supplied)

A fortiori, if Congress, in Section 36(b), which contains an express right of action, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary, it necessarily follows that Congress, in Section 36(a), where there is no such express right, did not intend to shift the responsibility for managing an investment company from the directors to the judiciary.

At bar, the District Court correctly analyzed and rejected the plaintiffs' argument based on the public policy of the Investment Company Act of 1940 and held (A. 18-19):

> "This Court cannot accept plaintiffs' argument that because the allegations of the complaint concern violations of the Investment Company Act and the Investment Advisers Act, the Board has no power to exercise its business judgment because of the strong public policies behind those Acts. Unlike § 16(b) of the Securities Exchange Act which allows shareholders to bring suit if the directors decline a demand, Congress has made no such statutory provisions with respect to suits brought

> under the Investment Company and Investment Advisers Act. It is true that causes of action under those Acts are implied rights of action. [citations omitted] It does not necessarily follow that because the right is implied a derivative suit should always be allowed despite the good faith exercise of business judgment by the directors not to sue. This court is of the opinion that absent a statutory exception, whether a cause of action is expressly authorized or is 'implied' the directors of a corporation should be given the chance to perform their duties in running the business of the corporation including whether to prosecute a cause of action. If they have exercised their business judgment in good faith then a decision not to sue should be final."

On a motion by plaintiffs for reargument, the District Court specifically addressed and rejected the Section 36(b) argument, and held, in an unreported opinion and order (A. 21):

> "That section [36(b)] specifically gives a security holder a cause of action against the investment adviser or an affiliated person on behalf of the investment company with respect to the receipt of compensation. The question of who should determine whether or not the corporation is to sue is different under section 36(a) . . . where the basis for suit is the more general claim of violation of fiduciary duty and where no cause of action is given in the statute to a security holder on such a claim."

The District Court correctly perceived the distinction between Sections 36(a) and 36(b); the Court of Appeals either misperceived or ignored the distinction and, in so doing, misconstrued the Investment Company Act of 1940.

Not only is there no provision of the Investment Company Act of 1940 which expressly or impliedly deprives the disinterested directors of their business judgment power but, to the contrary, there are several key provisions which indicate that Congress intended to vest power in the disinterested directors to determine matters of the highest importance and sensitivity to the fund and its shareholders.

Section 10(a) of the Investment Company Act of 1940 provides that at least 40% of the directors must be disinterested persons. It is these same so-called "minority directors" who have the critical responsibility of approving the terms of the advisory contract between the investment adviser and the fund under Section 15(c). The Court of Appeals did not believe that these directors could be truly disinterested and independent because they "must constantly deal with interested directors in a spirit of accomodation", and because "they are compelled for the most part to rely on the information and expert advice provided by the adviser and majority directors", and because their "continued service . . . for which in this case they were paid from $11,000 to $13,000 per annum, depends almost entirely on the establishment of satisfactory working arrangements between them and the majority . . ." (A. 46-47).* If Congress had shared the belief of the Court of Appeals, it surely would not have reposed such fundamental power in the disinterested directors.**

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* None of these three factors cited by the Court of Appeals is unique to disinterested directors of mutual funds, as opposed to disinterested directors of any other type of corporation. Thus, if these factors truly were disabling, no disinterested director of any type of corporation could ever function on matters involving interested directors. Cf. Delaware Corporation Law, Section 144.

** As the District Court stated in *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass.), *rev'd on other grounds*, 580 F.2d 22 (1st Cir. 1978) in discussing revised Sections 10 and 15 (79 F.R.D. at 45):

> "When Congress has rested such responsibility on the shoulders of the unaffiliated [i.e. disinterested] directors, it would be

The recent legislative history supports the powers of disinterested directors to exercise business judgment in matters of importance to the fund. In 1970 Congress amended the Investment Company Act of 1940. One of the important areas of amendment concerned the requirements for qualifying as an outside director. Throughout the 1960s there had been criticism that the outside directors were not truly functioning as "watchdogs". In the 1970 amendments, Congress revised and made stricter the requirements for qualifying as an outside director. Congress did so by providing that such persons not only could not be "affiliated" persons as defined in Section 2(a)(3), but also could not be "interested" persons as defined in a new section, Section 2(a)(19). In doing this, Congress believed that it had satisfied the criticisms of the prior test and enhanced the role of the outside directors. As Senate Report No. 91-184, 91st Cong., 1st Sess. at 32-33 (1969), reprinted in 3 U.S. Code Cong. & Ad. News at 4927 (1970) shows, Congress sought to "remedy the act's deficiencies in this regard" in order to assure that the disinterested directors would "supply an independent check on management and . . . provide a means for the representation of shareholder interests in investment company affairs". The decision of the Court of Appeals thus prevents the disinterested directors from performing the function envisioned for them by Congress in the 1970 amendments.

The relevant case law construing the statute also supports the power of the disinterested directors to exercise their business judgment as they did in this case. The Court of Appeals for the First Circuit in the leading case of *In re*

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anomalous to assume [that Congress believed] they are captive to the interests of the investment advisers."

Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973) has firmly rejected the argument that disinterested directors of a mutual fund are under a special disability in regard to exercising business judgment. The Court stated (479 F.2d at 266-7):

> ". . . the underlying business judgment may be sufficiently unsound to call for correction. But it does not follow that it is to be conclusively presumed in such a case that an unaffiliated, or disinterested director, if demand were made upon him, would be unable to exercise an independent judgment in considering what new course to take. [footnote and citation omitted]
>
> "*Nor do we think that an exception is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship.* Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. Normally self-dealing by any corporate directors is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. *In order to make sure that the directorate not be top-heavy, it* [Congress] *provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that,*

*as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from a disinterested director in any other corporate venture.** All disinterested directors must 'act honestly and according to their best judgment for the interests of all'. [citation omitted] When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim' [citation omitted], *it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response.* [citation omitted] *To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it.*" (emphasis supplied)

At bar, under the *per se* rule of disqualification adopted by the Court of Appeals, the disinterested directors were deprived of their opportunity to serve as "watchdogs" of the fund's best interests because they were erroneously *presumed* to be legally incapable of deciding on the appropriate corporate response.

The decision of the Court of Appeals is also in conflict with two of its own prior decisions on the applicability of the business judgment rule to disinterested directors of mutual funds.

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* If, as stated in *Kauffman, supra,* the disinterested directors of a mutual fund have the same fiduciary obligations as directors of other types of corporations, concomitantly they must have the same powers to fulfill those obligations, including the power, as shown in Point I, to prosecute or terminate litigation.

In *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir. 1977), *cert. denied*, 434 U.S. 934 (1978), the Court of Appeals recognized that the disinterested directors of a mutual fund have the authority to exercise a binding business judgment, even on matters as to which there is a conflict of interest on the part of the adviser and the interested directors of the fund (e.g., the allocation of brokerage fees on portfolio transactions of the fund) (552 F.2d at 417):*

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors."

In *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the Court of Appeals also affirmed the applicability of the business judgment rule to disinterested directors of mutual funds. Chief Judge Friendly there wrote (533 F.2d at 749-50):

> "Congress had mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs'. [citation omitted] The minimum requirement to enable the Fund's independent directors to discharge these duties with respect to recapture was

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* The SEC, at the request of the Court of Appeals in *Tannenbaum, supra,* submitted an *amicus curiae* brief. In that brief, the SEC expressly acknowledged the power of disinterested directors of mutual funds to make business judgments on matters as to which there may be a conflict of interest between the advisor and the fund, provided three conditions are met: 1. the directors are independent; 2. the directors are informed; and 3. the business judgment is reasonable. These conditions were clearly met in the case at bar.

a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of recapture methods and their legal consequences performed by disinterested counsel furnished to the independent directors.

"If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort at recapture, we would have a different case."

At bar, the disinterested directors concluded that "because of legal doubts, business considerations or both" maintenance of this litigation was contrary to the interests of the fund and its shareholders. Nothing in the Investment Company Act of 1940, its legislative history or the relevant case law deprives the disinterested directors of their power to reach and act upon such a conclusion.

POINT III

The Court of Appeals erred in failing to follow the rule of this Court that state corporate law governs internal corporate affairs in the absence of an express federal statutory provision to the contrary.

This Court has specifically held that, in the absence of any *express* federal statutory provision to the contrary, state law governs the internal affairs of a corporation, including the powers of the directors. Thus, in *Santa Fe*

Industries, Inc v. *Green,* 430 U.S. 462 (1977), this Court last year wrote (430 U.S. at 479):

"Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law *expressly* requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation." (quoting from *Cort* v. *Ash,* 422 U.S. 66, 84 (1975)) (emphasis in original)

Fundamental, the mutual fund involved in this case, is a Delaware corporation.* Section 141 (a) of the Delaware Corporation Law empowers the board of directors of a corporation to manage the affairs of the corporation. No distinction is made under that law for mutual fund corporations.** Management of the affairs of a corporation has long been held to include the power to decide whether or not to pursue a possible claim of the corporation in litigation. See, e.g., *McKee* v. *Rogers,* 18 Del.Ch. 81, 85-6, 156 A. 191, 193 (Ch. 1931), where the Chancellor stated:

"Of course a stockholder cannot be permitted as a general rule to invade the discretionary field committed to the judgment of the directors and sue in the corporation's behalf when the managing body refuses."

* Congress, when it enacted the Investment Company Act of 1940, left the organization of mutual funds to state law. Mutual funds are creatures of state law, *not* (like national banks, for example) creatures of federal law.

** See, e.g., *Lutz* v. *Boas,* 39 Del.Ch. 585, 608, 171 A.2d 381, 395 (Ch. 1961), where then Chancellor Seitz (now Chief Judge of the Court of Appeals for the Third Circuit) wrote: "The non-affiliated directors [of a mutual fund] had the same responsibility as that of the ordinary directors of a Delaware corporation." If the directors have the same responsibilities under Delaware law, it follows that they must have the same powers to fulfill those duties.

The Court of Appeals, however, erroneously differentiated between mutual fund directors and directors of other types of business corporations with respect to their business judgment power to determine whether or not litigation on behalf of the corporation should be prosecuted. See Point II. In so doing, the Court of Appeals engrafted onto the Investment Company Act of 1940 new limitations on the powers of mutual fund directors *not* placed there by Congress and in conflict with the plan of corporate governance intended by the law of Delaware.

The Court of Appeals did not and could not cite any provision of federal law which expressly overrides or abrogates the power of the directors under state law. The fact is that there is no such provision in the Investment Company Act of 1940 or in any other federal statute. Thus, the decision of the Court of Appeals is in conflict with the principles clearly enunciated by this Court in *Santa Fe* and *Cort, supra.*

The Court of Appeals also erroneously stressed the fact that the decision was made by "minority directors," i.e., five of 11 members of the Board (see A. 39, 40, 42, 43, 45, 47 and 48). Under Article VI of Fundamental's by-laws (A. 143) and under Delaware Corporation Law, Section 141 (b), the five disinterested directors constituted a quorum—indeed, more than a quorum. As such, they had the full power of the Board of Directors under Delaware Corporation Law, Section 141 (a). In addition, Delaware Corporation Law, Section 144 expressly empowers disinterested directors to pass upon corporate matters involving interested directors.

The decision by the Court of Appeals in this case directly contravenes these grants of authority to the quorum and, in effect, legislates new provisions of corporate law not provided for by Delaware or by Congress.

CONCLUSION

The judgment of the Court of Appeals should be reversed and the Complaint should be dismissed.

Respectfully submitted,

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November 16, 1978

ADDENDUM A

TEXT OF STATUTES INVOLVED

INDEX TO ADDENDUM A

ADDENDUM A

Text of Statutes Involved

Delaware Corporation Law

Sections 141(a) and (b) of the Delaware Corporation Law, Del. Code tit. 8, §§ 141(a), (b) (1975):

§ 141. Board of directors; powers; number, qualifications, terms and quorum; committees; classes of directors; non-profit corporations; reliance upon books; action without meeting, etc.

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of one or more members. The number of directors shall be fixed by, or in the manner provided in, the by-laws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the by-laws. The certificate of incorporation or by-laws may

prescribe other qualifications for directors. Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the by-laws require a greater number. Unless the certificate of incorporation provides otherwise, the by-laws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than one-third of the total number of directors except that when a board of one director is authorized under the provisions of this section, then one director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the by-laws shall require a vote of a greater number.

Section 144 of the Delaware Corporation Law, Del. Code tit. 8, § 144 (1975):

§ 144. Interested directors; quorum

(a) No contract or transaction between a corporation and one or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which one or more of its directors or officers are directors or officers, or have a financial interest, shall

be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if;

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction.

Investment Company Act of 1940

Section 2(a)(3) of the Investment Company Act of 1940, 54 Stat. 790, 15 U.S.C. § 80a-2(a)(3) (1976 ed.):

§ 80a-2. Definitions

(a) When used in this subchapter, unless the context otherwise requires—

* * *

(3) "Affiliated person" of another person means (A) any person directly or indirectly owning, controlling, or holding with power to vote, 5 per centum or more of the outstanding voting securities of such other person; (B) any person 5 per centum or more of whose outstanding voting securities are directly or indirectly owned, controlled, or held with power to vote, by such other person; (C) any person directly or indirectly controlling, controlled by, or under common control with, such other person; (D) any officer, director, partner, copartner, or employee of such other person; (E) if such other person is an investment company, any investment adviser thereof or any member of an advisory board thereof; and (F) if such other person is an unincorporated investment company not having a board of directors, the depositor thereof.

Section 2(a)(19) of the Investment Company Act of 1940, 84 Stat. 1413, 15 U.S.C. § 80a-2(a)(19) (1976 ed.):

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company

solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso;

* * *

Section 10(a) of the Investment Company Act of 1940, 54 Stat. 806, as amended, 84 Stat. 1416, 15 U.S.C. § 80a-10(a) (1976 ed.):

§ 80a-10. Affiliations or interest of directors, officers, and employees

(a) Interested persons of company who may serve on board of directors

No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

Section 15(c) of the Investment Company Act of 1940, 54 Stat 812, as amended, 84 Stat. 1419 and 89 Stat. 165, 15 U.S.C. § 80a-15(c) (1976 ed.):

§ 80a-15. Contracts of advisers and underwriters

* * *

(c) Approval of contract to undertake service as investment adviser or principal underwriter by majority of noninterested directors

In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for

any registered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

Sections 36(a) and (b) of the Investment Company Act of 1940, 54 Stat. 841, as amended, 84 Stat. 1428, 15 U.S.C. §§ 80a-35(a), (b) (1976 ed.):

§ 80a-35. Breach of fiduciary duty

(a) Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection

of investors and to the effectuation of the policies declared in section 80a-1(b) of this title.

(b) Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payment received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a-17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a-9 and 80a-48 of this title, section 78*o* of this title, or section 80b-3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

ADDENDUM B

Stephens Letter, December 31, 1974

ADDENDUM B

Stephens Letter, December 31, 1974

(Letterhead of)

WILLIAM J. STEPHENS
21 Live Oak Road
Hilton Head Island, South Carolina 29928

December 31, 1974

Re: The Derivative Action
Lasker et al
February 1973

Dear Leon,

At this date I wish to advise that my tentative conclusion is that, in the best overall interest of Fundamental Investors, Inc., this derivative action should not be prosecuted and should therefore be dismissed.

I have given consideration to the following:

#1—Judge Stanley H. Fuld's statement contained in his letter of December 5, 1974 which reads—"As a result of my analysis of the facts and the law, it is my opinion that there was no violation by Anchor or by the Fund directors of any provision of statute or of any common law or contractual obligation to the Fund, in connection with the acquisition and retention of the Penn Central commercial paper."

#2—There is no hard evidence that the adviser did not exercise due care and diligence in the Penn Central transaction. The certain guidelines established for the purchase of commercial paper from dealers are evidence that this transaction was not entered into lightly. It is reasonable to conclude the guidelines were truly a sufficient safeguard.

#3—It is also reasonable for the adviser to place reliance on the presentation and recommendation of Goldman, Sachs & Co., a most astute, prestigious and highly regarded investment banker.

#4—As a purchaser, Anchor was in "first class" company and this conclusion was arrived at by an examination of the "Investor Sales Analysis" from 3/1/68 to 4/2/70, a 12 page document prepared by Goldman, Sachs & Co. Also examined was the list of 73 banks that bought and/or sold Penn Central paper, mostly for the account of customers. It seems evident that the investment community highly regarded the Penn Central commercial paper and purchased it as late as 4/2/70. The statement showed sales of $172,505,000 in this period, not including the $20,000,000 purchased by Anchor. The amount not paid at maturity was $52,205,000 including the $20,000,000 Anchor buy.

#5—Commercial Paper was fully accepted by the investment community. The outstanding commercial paper in the first part of 1970 exceeded $40 billion.

#6—In August 1968 the Interstate Commerce Commission gave Penn Central authority to sell $35 million in commercial paper. On December 17, 1968 the I.C.C. increased the authorization to $100 million. On May 18, 1969 Penn Central announced an increase to $150 million, approved by the I.C.C. On October 29, 1969 the I.C.C. agreed to permit the sale of up to $200 million. At this time the comment on the decision by the I.C.C. to increase to $200 million was, "On the whole, applicant is in a strong financial condition."

#7—Penn Central had a $50 million revolving credit plan. In April 1969, with First National City as the lead bank, the amount of the revolving credit was increased to $300 million. All $300 million was used by the railroad, which eventually defaulted on the loan. There were about ninety banks involved; the majors were First National City $35 million, Irving Trust and Morgan Guaranty $25 million each, Manufacturers Hanover $20 million, with Bankers Trust of New York, Chemical Bank New York Trust, First National Bank of Chicago and Continental Illinois Bank at $15 million each. It is clear the banks did not contemplate that the railroad would be bankrupt within 14 months!

#8—Of more than passing interest is the interlocks of Penn Central directors with the major banks of Penn Central and the railroads indebtedness to these banks as of May 12, 1970.

Director	*Bank*	*Amount*
S. Saunders	Chase Manhattan	$ 7,832,500
	First Pennsylvania	18,004,766
D. Bevan	Provident National	57,074,895
P. Gorman	Bankers Trust	26,063,106
J. T. Dorrance, Jr.	Morgan Guaranty	90,972,957
A. E. Perlman ...	Marine Midland	1,083,651
R. S. Rauch, Jr. ..	Girard Trust	49,408,188
R. G. Rincliffe ...	Philadelphia National	12,480,000
	Total	$262,920,063

On June 8, 1970 International Utilities was the largest shareholder of Penn Central with 500,000 shares. They were in the midst of taking a loss of

$8 million on their holdings. John Seabrook was Chairman of International Utilities and a Director of Penn Central.

Also it is to be noted that the total railroad indebtedness to First National City was more than $300 million. They were not represented on the Board of Penn Central.

My only comment on this is the observation that the Directors did not know or understand the "soft under belly" of the railroad until it was too late. Question?—If the Directors did not grasp the real financial posture of Penn Central, was it possible for Anchor to reach behind the scenes and get the true picture?

#9—On merger day February 1, 1968 Penn Central had assets of $6.5/7.0 billion. In just 871 days later, on June 21, 1970, bankruptcy proceedings were filed under Section 77. Penn Central was regarded as the backbone of the country's transportation system and had a "Rock of Gibraltar" stature. "Nothing can happen to Penn Central" was accepted in financial centers across the nation. "The banks are behind Penn Central," was regarded as Gospel.

#10—In part, my conclusion that the Lasker derivative action should not be prosecuted stems from my concern about the possible impact on *Anchor and Fundamental Investors, Inc.*

First, as to Anchor:

The amount involved exceeds the total assets of Anchor and, if the award was made, Anchor would cease to be a viable organization. Their

ability to attract and retain skilled fund managers would be gone. It would indicate that the Fund Board believed Anchor had violated the law and breached their contractual obligations to the Fund. I do not so believe. It would be inconsistent to retain Anchor as the Fund adviser and join in a suit against them at the same time. Would the Fund flounder in the interim of changing advisers? I fear so.

Second, as to the Fund:

The impact on the Fund, as a result of public knowledge that the Board had become a plaintiff in prosecuting Anchor would probably result in heavy redemptions. This would compel distress selling of the Portfolio in the current depressed market. As of November 30, 1974, Total Net Assets were $531 million, Short Term investments $21 million, Cash and Receivables $15 million. Net Asset Value per share was $5.13. Recovery of the total amount represents about $.13 a share which is 2½%. The Net Asset Value of the shares, I believe, would be damaged by a far greater percentage if the Board supported the suit. I do not make light of the sum involved but wanted to put it into perspective.

#11—It is my tentative business judgment that the Lasker suit is without merit and that it would not prevail.

Addendum B—Stephens Letter, December 31, 1974

Summary

These are my thoughts at this time. I will await answers to some questions that other Directors and I have asked before coming to a final conclusion.

Respectfully submitted,

s/ William J. Stephens

wjs/hl

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., EDWARD B. BURR, THOMAS F. CHALKER, JOHN R. HAIRE, HARVEY C. HOPKINS, S. P. HUTCHISON, DONALD L. KEMMERER, A. S. MIKE MONRONEY, CHARLES F. PHILLIPS, JEPTHA H. WADE, ANCHOR CORPORATION and FUNDAMENTAL INVESTORS, INC.,

Petitioners,

—v.—

HOWARD M. LASKER and IRVING GOLDBERG,

Respondents.

RESPONDENTS' BRIEF

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Petitioners,

—v.—

HOWARD M. LASKER and IRVING GOLDBERG,

Respondents.

RESPONDENTS' BRIEF

Question Presented

Can minority directors of a registered mutual fund who were nominated by the majority directors of the fund to be "independent" directors pursuant to the requirements of the Investment Company Act terminate a validly commenced nonfrivolous stockholder's derivative action against the fund's majority directors and its investment adviser based upon violations of the Act and other breaches of fiduciary duties?

Statutory Provisions Involved

The following statutory provisions are involved:

Section 1 of the Investment Company Act, codified in 15 U.S.C. §80a-1 (1976) (at pp. 1006-07);

Section 13(a)(3) of the Investment Company Act, codified in 15 U.S.C. §80a-13(a)(3) (1976) (at p. 1027);

Section 17 of the Investment Company Act, codified in 15 U.S.C. §80a-17 (1976) (at p. 1033);

Section 36 of the Investment Company Act as it existed prior to December 14, 1970, Act of Aug. 22, 1940, ch. 686, Title I, §36, 54 Stat. 841;

Section 206 of the Investment Advisers Act, codified in 15 U.S.C. §80b-6 (1976) (at p. 1070);

Rule 23.1 of the Federal Rules of Civil Procedure.

Statement of the Case

The decision of the District Court permitted a minority of a board of directors to dismiss a validly commenced derivative action alleging serious, factually detailed, and largely substantiated charges of wrongdoing against their co-fiduciaries on the basis of business judgment. That determination was the first judicial approval of such a procedure. The District Court's action was a drastic departure from settled doctrine governing the prosecution of derivative suits. The Second Circuit unanimously reversed.

If the procedure approved by the District Court is reinstated here, the net effect will be to curtail gravely, if not to destroy, shareholder enforcement of derivative claims seeking redress for insider abuses. A new and potent weapon will have been manufactured to frustrate private enforcement of the securities laws. Implied rights will exist, but they will be unenforceable. Corporate responsibility will not be promoted. The boardroom will simply be left to its own unfettered schemes.

This is a stockholders' derivative action brought on behalf of Fundamental Investors, Inc. (the "Fund"), a federally regulated mutual fund, seeking recovery of investment losses sustained in connection with the Fund's purchase of $20,000,000 worth of nine-month Penn Central Transportation Company commercial paper prior to that company's financial collapse. Defendants in the case, petitioners herein, are the Fund's investment adviser, Anchor Corporation ("Anchor"), and the Fund's directors at the time of the acts complained of. Plaintiffs' claims arise under the Investment Company Act of 1940, the Investment Advisers Act and the common law.

The Investment in Penn Central Paper

Between November 28, 1969 and December 8, 1969, Anchor caused the Fund to purchase Penn Central notes as a purported liquidity measure from Goldman, Sachs & Co., an investment banking house (A. 86). Goldman, Sachs, in selling the notes to the Fund, was a principal acting for its own account (A. 84-85). These purchases were the largest investment made by the Fund during that period.

In consummating the transactions for the Fund, Anchor did not conduct any independent research or analysis whatsoever (A. 86, 95). Anchor also violated two out of the three investment guidelines which it had established to safeguard the Fund in connection with the purchase of commercial notes from dealers: (i) it failed to include an automatic buy-back provision as a condition of purchase and (ii) it caused the Fund to hold more than ten percent of an outstanding issue (A. 84, 109, 113).

Anchor failed to do any initial investigation before the purchases and made them in spite of adverse information which was publicly available on October 20, 1969 and in November. *University Hill Foundation* v. *Goldman, Sachs & Co.*, 422 F. Supp. 879, 889 n.10, 889-90 (S.D.N.Y. 1976). After the purchases Anchor did nothing to inform itself as to Penn Central's increasingly precarious financial condition, in gross neglect of its legal and moral responsibilities to the Fund's shareholders (A. 101). An adverse public report was rendered on February 4, 1970. *Franklin Sav. Bank* v. *Levy*, 551 F.2d 521 (2d Cir. 1977). Still, Anchor did not act. Even Penn Central's staggering first quarter 1970 losses of $62.7 million reported in the *Wall Street Journal* on April 23, 1970 failed to move Anchor to action (A. 103).

Apparently oblivious to the mounting warning signals of impending disaster, which were widely reported in the financial press, Anchor made no effort to sell the commercial paper until an article appeared in the May 18, 1970 issue of *Barron's*, which expressed doubt about the safety of commercial paper generally. This article, which did not refer to Penn Central specifically, caused Anchor to seek to reduce the Fund's Penn Central holdings by one-half (A. 87). By this time, however, no one was buying the paper and the Fund continued to hold it when Penn Central filed its petition for reorganization on June 21, 1970 (A. 87, 113).

Anchor, which received advisory fees from the Fund of approximately $4,000,000 a year, had remained in a state of complete ignorance from start to finish.

The disingenuous rationalization offered by Anchor for its failure to do any investigation or review in connection with the purchase and retention of Penn Central paper was that if Goldman, Sachs sold the paper, it must have

been creditworthy (A. 101-02). As a highly paid fiduciary whose responsibilities were to render sophisticated investment advisory services for the benefit of the Fund's shareholders, Anchor recklessly failed to perform any services whatsoever.

The Fund's directors, whose responsibilities were to oversee and supervise the activities of the adviser, similarly failed the shareholders. They were unaware of the procedures being used by Anchor or even that Anchor had begun buying commercial paper from dealers (A. 108).

The Disingenuous Scheme to Terminate This Action

On October 28, 1970, the Fund's Board of Directors met to discuss the Penn Central losses and decided to begin an action against Goldman, Sachs. The directors also decided not to pursue an action against Anchor or others at that time but to defer any decision with respect to such an action until after the Fund's suit against Goldman, Sachs (A. 157; Doc. 10,* Phillips' Affd. ¶7, June 19, 1973). That suit was instituted in November 1970 and settled in July 1974 for $5¼ million—only twenty-five percent of the loss—plus an interest in the potential proceeds of the bankruptcy (A. 87).**

* This and similar references are to the documents in the record numbered in accordance with the Index to the Record filed by plaintiffs in the Court of Appeals.

** Investors Diversified Services makes an awkward attempt to denigrate the present value of plaintiffs' claims because a plan of reorganization was approved for Penn Central. The certificates of beneficial interest to which IDS refers have no established trading value. Their ultimate worth to the Fund, if any, is highly speculative and is contingent on the outcome of certain litigation against the United States concerning the valuation of Penn Central property. *See* Wall St. J., Oct. 25, 1978 at 34, col. 3; *id.*, Mar. 10, 1978 at 37, col. 1. IDS also neglects to mention that interest on plaintiffs' claims, which defendants concede is running, is presently in excess of $7,000,000.

The present suit was begun in February 1973 and was stayed pending determination of the suit against Goldman, Sachs. In granting the stay, Judge Gurfein required all defendants to execute waivers of the statute of limitations. When the Goldman, Sachs case was settled, the stay was lifted and the question of what to do about Anchor and the instant litigation was again at hand (Haire Tr. 175-76). Defendant John R. Haire, President of the Fund and Chairman of Anchor, and Mr. Roger T. Wickers, an officer of the Fund and Anchor (but not a director of the Fund), both lawyers, devised a plan to use those five of the Fund's eleven directors who were not defendants in the case or affiliated with Anchor to bring about a dismissal of this action (Haire Tr. 239, 244-45).* The plan was successfully orchestrated and executed in the following manner:

(1) Haire instructed Wickers to explore the retention of special counsel (Haire Tr. 247, 250). Wickers ascertained that retired Judge Stanley H. Fuld would be available (Haire Tr. 250-51, 254).

(2) Thereafter, at the next Fund board meeting, Wickers presented to the directors a proposal that a disinterested "minority quorum" consider the Fund's position with respect to the litigation (Kendall Tr. 104-06; Stephens Tr. 48-49). Wickers suggested several persons who might be retained to act as special counsel and specifically stated that Judge Fuld was available (Kendall Tr. 125). The five minority directors agreed to look into the matter and told Wickers to contact Judge Fuld and have him review the case (A. 157; Haire Tr. 262).

(3) Judge Fuld was subsequently retained. He conducted an investigation and rendered a report in which he expressed his opinion that the present case against Anchor and the Fund's directors was without merit (A. 82). Judge Fuld based his conclusion on what he believed to be an absence of any direct legal authority on the issue of whether an investment adviser is required to conduct independent research in connection with investment recommendations (A. 96, 97, 100, 102, 108). As is shown in Point V(B), this opinion was erroneous.

* This and similar references are to transcripts of depositions taken pursuant to the District Court's first opinion (A. 20).

(4) Based largely on (i) Judge Fuld's mistaken conclusion that this case lacked merit and (ii) an irrational fear that if the action went forward an adversary relationship would ensue between Anchor and the Fund requiring the termination of Anchor's advisory contract,* the five minority directors determined to seek dismissal of the instant suit against Anchor and their brethren directors (A. 77-8).

(5) All defendants then moved to dismiss the action on the basis of the business judgment of the minority directors.

The District Court specifically declined to consider the merits of this case and held, as a matter of law, that the minority directors had the power to act to terminate this action provided they did so in good faith (A. 19). Since plaintiffs had raised an issue as to the actual independence of the minority directors, the Court ordered discovery restricted solely to the issue of the relationship between the minority directors and the Directors' Qualifications Committee which had selected them (A. 20).

The Minority's Lack of Independence

Although discovery was severely limited by the District Court's order, it nonetheless disclosed numerous factors

* As discussed *infra*, pp. 11-12, the disinterested quorum took a completely opposite viewpoint in subsequently approving a transfer of Anchor's services in a transaction in which Anchor received $4,000,000.

precluding any possible determination that the minority directors, under the circumstances of this case, could have exercised independent judgment.*

(1) The so-called quorum constituted only a minority of the Fund's board, the remaining six directors being either alleged wrongdoers or affiliated with Anchor, or both. Each member of the quorum had been screened, selected and nominated for office by Anchor and the individual defendants who, as majority directors, at all times had the absolute power to effect their removal.

(2) The quorum directors were simultaneously selected for and held identical positions with the other five funds within the Anchor Group of Mutual Funds for which they received remuneration of from $11,000 to $13,000 per year (Haire Tr. 21-22; Doc. 76, Tersigni Affid., Sept. 20, 1976, Exh. G).

(3) Members of the quorum were friends with one or more of the defendants, with whom they had long histories of business and social contacts prior to joining the boards of Anchor's funds.

(4) The Fund itself was little more than a corporate shell totally dependent on Anchor for its operational existence. Anchor's domination and control of the Fund was complete at all levels. Anchor supplied and paid the salaries of all Fund officers, executive and administrative personnel. Anchor supplied, at its own expense, the Fund's office space (at Anchor's headquarters) and all office equipment, supplies and services (Haire Tr. 38-39; Doc. 84, Pls. Exh. 1, Advisory Contract, p. 2).

(5) Anchor held all key executive positions. Mr. Haire, Anchor's Chairman, was the Fund's President and Chief

* See Point V(A), *infra*.

Executive Officer, as well as a director. Mr. Burr, Vice-Chairman of Anchor, was Chairman of the Fund's board. Mr. Martin, President and a director of Anchor, was Executive Vice President of the Fund and a director. Mr. Hutchison, President and a director of Washington National Corporation, Anchor's parent company, was also a director of the Fund (Doc. 60, Fund Prospectus, May 1, 1974, p. 19).

(6) Defendants, as a majority of the board, controlled the Fund's proxy machinery. The Fund had in excess of 104,000,000 shares owned by approximately 141,000 shareholders (Doc. 76, Tersigni Affid., Sept. 20, 1976, Exh. H). No shareholder owned more than one percent of the stock (Doc. 76, Tersigni Affid., Sept. 20, 1976, p. 2). The cost of a proxy contest by the members of the minority would have been prohibitive. Waging such a contest would not have been a feasible alternative for any attempted assertion of control by the minority directors.

Despite overwhelming evidence that the minority directors were not in fact independent and had reached their decision on inaccurate assumptions, the District Court, finding no indication that the quorum had acted other than independently, held that it could not substitute its judgment for that of directors (A. 28). In somewhat startling language, the District Court concluded, "[h]ere, there has been no showing by the plaintiff of facts which, if proven, would prohibit the defendants from *hiding behind the business judgment cloak*" (A. 38) (emphasis added). Without joinder of issue or any discovery on the merits or an opportunity to examine special counsel,* the District Court granted summary judgment for defendants.

* It is significant to note that neither the minority directors nor special counsel saw fit to solicit the views of plaintiffs' counsel.

The Court of Appeals' Decision

The Court of Appeals unanimously reversed on the facts and the law and remanded the case for proceedings on the merits. The Court of Appeals carefully examined the relationship of the minority directors to the defendants and concluded, "it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires" (A. 47). The Court of Appeals further found that there was a "symbiotic relationship" between the Fund and Anchor and that the minority directors "owe[d] their position as directors to the defendants in the suit" (A. 48 n.14). Based upon a further finding that the plaintiffs' claims were substantial and meritorious, the Court concluded that the policies of the Investment Company Act precluded dismissal at the behest of the minority directors. The Court stated

> It is undisputed that Anchor never made any independent investigation of Penn Central's financial situation before the Fund's purchase of the notes. Moreover, although reports of Penn Central's operations in early 1970 showed mounting losses, it was not until May that the Fund officers made any attempt to resell any part of the notes to Goldman, Sachs, or otherwise to realize on the investment. . . .
>
> . . .
>
> From what this record discloses regarding the Fund's investment in Penn Central notes on Anchor's advice, we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses. We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.

A. 40-41, 43.

Defendants' petition for a rehearing in banc was denied by the Court of Appeals, following which this Court granted *certiorari*.

The Subsequent Transfer of Anchor's Advisory Services

The Court of Appeals' decision was rendered on January 11, 1978. On February 10, 1978 Anchor announced that an agreement in principle had been reached to transfer its advisory and underwriting services for all funds within the Anchor Group to Capital Research and Management Company (Fund Proxy Statement, June 12, 1978). Anchor's parent, Washington National Corporation, was paid $4,000,000 for the transfer (*New York Post,* Aug. 2, 1978, p. 83).* Of critical importance is the fact that Anchor no longer is the Fund's adviser. Thus, the pur-

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* Litigation was commenced which challenged the transaction. In rejecting the challenge, the court referred to the fact that in approving the transfer six directors had "discussed the poor investment results which had been achieved by the Anchor Group of Funds. . . ." Reserve Management Corp. v. Anchor Daily Income Fund, Inc., [Current] Fed. Sec. L. Rep. (CCH) ¶96,566 at p. 94,367 (S.D.N.Y. 1978). Five of those six directors are the same individuals who constituted the minority group which deter-

ported business justification given by the directors for seeking to bar further prosecution of this litigation no longer has any colorable basis in fact or reason.

There Has Been a Substantial Change in Circumstances Which Suggests That the Writ of Certiorari Should Be Dismissed

The basic thread which runs through the argument submitted in support of the Petition For A Writ of Certiorari and in support of defendants' arguments before this Court is that continued prosecution of this action would be highly detrimental to the Fund because it would place it in an adversary relationship with its adviser, Anchor.

At the time the Petition herein was filed, June 2, 1978, we were unaware of the fact that on February 10, 1978 Anchor had announced an agreement in principle to transfer its advisory and underwriting services to an independent company for $4,000,000.*

As noted above, that transfer has now been completed and Anchor no longer has any relationship with the Fund. It is, therefore, impossible for any party to suggest that disruption of the working relationship between Fundamental and Anchor furnishes a reasonable basis for reversal.

In this regard, it is significant to note that defendants never advised the Court of this impending transaction:

mined that this action should be dismissed (*id.* at p. 94,365). Also, the court noted that a proposal had been made by another adviser to become the Fund's adviser but to continue existing Anchor investment management personnel. This proposal "apparently was unanimously rejected out-of-hand by the independent directors" (*id.* at p. 94,367).

* This included all funds within the Anchor Group.

it is not mentioned in the Petition or in the briefs submitted by any of the parties.* We first become aware of the transfer when litigation concerning it was reported in the newspapers in August, 1978.

In these circumstances, we respectfully suggest that it would be appropriate for this Court to dismiss the writ of certiorari since one of the fundamental issues raised has been rendered moot. *See Bankers Trust Co.* v. *Mallis*, 435 U.S. 381, *reh. denied*, 436 U.S. 915 (1978); Stern & Grossman, Supreme Court Practice §5.15 (1978 ed.).

Summary of Argument

Plaintiffs' basic position is that the minority directors of the Fund had no power or authority to request the dismissal of this action. In short, the application should have been denied out-of-hand.

Our assertion of lack of power to even bring the issue before the court arises from several sources:

A. As found by the Second Circuit, the Investment Company Act of 1940 does not contemplate that disinterested directors should possess such power and, indeed, negates the existence thereof.

B. Under Rule 23.1, a threshold question in any derivative action is that of demand. A demand is excused whenever a numerical majority of the board is disqualified. We submit that the device employed by the defendants here would render the demand rule meaningless.

* The *amicus* brief of IDS cites the related *Reserve* litigation concerning the proposed transfer as support for certain of its arguments (Br. pp. 38 n.31, 49 n.36) but avoids any disclosure of the underlying facts.

C. We have found no case where a minority quorum has been able to dismiss a nonfrivolous derivative action. All of the applicable authority mandates a contrary resolution of the issue. Indeed, with the exception of two cases decided after the District Court's decision here, we know of no decision where a court has even entertained a dismissal application at the behest of a minority quorum.

D. Concepts developed to assure fair access to the federal courts to redress violations of federal law and accepted state standards with respect fiduciary obligations bar the minority quorum from seeking dismissal of this action.

Moreover, we submit that even if the application to dismiss was properly before the District Court, that application should have triggered a full hearing pursuant to Rule 23.1, including an exploration of the merits of the basic action, the appropriateness of the dismissal recommendation and the overall fairness to the stockholders. On the record before this Court there is no doubt that any such application to dismiss should have been denied.

The procedure which defendants urge upon this Court is fraught with difficulties. If sanctioned, it would grant to minority directors a hitherto nonexistent power to terminate validly commenced nonfrivolous derivative actions. The Investment Company Act clearly does not contemplate that such awesome power be granted to "independent" directors in the guise of enhancing their roles as "watchdogs." Indeed, the Act contemplates that the additional powers granted to independent directors be used to enhance the rights of and protections afforded to shareholders —not diminish them.

Moreover, if generally applied to all corporations, the procedure here would be subject to grave abuse and would unduly complicate and extend shareholder litigation. For

example, if a corporation had a ten-person board and only one or two directors were disinterested, could they be constituted a committee to review and seek dismissal of an action commenced against their co-directors?

Moreover, plaintiffs would find it difficult, if not impossible, to ferret out the many subtle influences placed upon the minority which might impel it to seek dismissal.

Considerations of fairness, certainty and avoidance of extensive litigation all point to the impropriety of the position urged by the defendants in this litigation.

POINT I

The Policy of the Investment Company Act and the Limited Authority of Statutorily Disinterested Directors Thereunder Demonstrate That Such Directors Lack the Power to Seek the Termination of This Litigation.

Plaintiffs' right to bring this action derives from rights arising under the Investment Company Act and the Investment Advisers Act and compliance with the standing requirements of Rule 23.1 of the Federal Rules of Civil Procedure. *See Abrahamson* v. *Fleschner,* 568 F.2d 862, 873 (2d Cir. 1977), *cert. denied,* 436 U.S. 905 & 913 (1978); *Galfand* v. *Chestnutt,* 545 F.2d 807 (2d Cir. 1976); *Moses* v. *Burgin,* 445 F.2d 369, 373 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Kauffman* v. *Dreyfus Fund, Inc.,* 434 F.2d 727, 734 (3d Cir. 1970), *cert. denied,* 401 U.S. 974 (1971); *Levitt* v. *Johnson,* 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965); *Brown* v. *Bullock,* 194 F. Supp. 207, 220-28 (S.D.N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

Defendants have never challenged plaintiffs' right to bring this action.* The issue raised here is whether the

* Defendants concede that "the existence of a private right of action [is] a subject *not* at issue in this case . . ." (Pet. Br. 28)

Fund's minority directors have the power to request the courts to terminate the action. The Court of Appeals held they did not. An analysis of the Investment Company Act and its purposes fully supports the Court's ruling.

A. *Sections 1 and 17 of the Investment Company Act Embody a Strong Congressional Policy of Protecting Shareholders Against Insider Abuse. This Policy Precludes Dismissal of This Action.*

Both the Investment Company Act and Investment Advisers Act were enacted in 1940 as a comprehensive federal regulatory scheme for the protection of investors. The registration and disclosure provisions of the 1933 and 1934 federal securities laws were deemed inadequate to cope with the managerial abuses found to be the order of the day in the mutual fund industry. *See Tannenbaum* v. *Zeller,* 552 F.2d 402, 406 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977); *Brown* v. *Bullock,* 194 F. Supp. 207, 217, 223 (S.D. N.Y.), *aff'd,* 294 F.2d 415 (2d Cir. 1961).

In enacting the 1940 legislation, Congress sought to place the entire operation and management of the mutual fund industry under specific and comprehensive regulation. In *Brown* v. *Bullock, supra,* 194 F. Supp. at 232-33, the court observed

> In certain major respects, the 1940 Act operates as a corporation law for investment companies. . . .
>
> In light of the distinctive character of investment companies and their easy susceptibility to management

(emphasis added). Santa Fe Indus., Inc. v. Green, 430 U.S. 462 (1977) and Cort v. Ash, 422 U.S. 66 (1975), upon which much of their argument is based, involved the question of whether a federal implied right of action existed. Those cases are inapposite. Here, the question is whether the defendants can use a nonexistent state procedural device to evade substantive statutorily-based federal liability.

> abuses . . ., one of the primary objectives of the 1940 Act was the protection of investment companies as well as investors against the derelictions of investment companies' directors, investment advisers, other fiduciaries, and principal underwriters.

In Section 1 of the Investment Company Act, 15 U.S.C. §80a-1, Congress set forth its "Findings and declaration of policy," which make it clear that state regulation of investment companies is inadequate for shareholder protection and that the Act is to be interpreted so as to ensure that such companies are operated and managed for the benefit of the shareholders, not the directors or the adviser. Section 1(a)(5) thus provides

> [I]t is found that investment companies are affected with a national public interest in that, among other things—
>
> . . .
>
> (5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

See Harriman v. *E. I. DuPont de Nemours & Co.,* 411 F. Supp. 133, 159 (D.Del. 1975).

Section 1(b) provides in no uncertain terms that "the national public interest and the interest of investors are adversely affected— . . . (2) when investment companies are organized, operated, [or] managed . . ., in the interest of directors, officers [or] investment advisers . . ., rather than in the interest of all classes of such companies' security holders."

Section 1 goes on to provide

> It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

In implementing these provisions, Congress prohibited board ratification of various insider transactions which might otherwise be permissible under state corporate law (Section 17, 15 U.S.C. § 80a-17) and also provided in Section 17(h) for an absolute ban on any clause in any corporate instrument, including the by-laws, which protects or purports to protect an officer or director of an investment company from liability of the kind alleged in the present action.* The procedural ploy attempted by defendants in this case flies squarely in the face of the congressional policy set forth in Sections 1 and 17 of the Act, which defendants nowhere mention.

In *Brown* v. *Bullock*, 194 F. Supp. 207, 237 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961) the court said, "[a]n attempt to immunize a possible violator of the statute

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* Section 17(h) of the Investment Company Act provides in part

> After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

against liability for his violation was deemed by Congress to be so offensive as to be stricken down as void *ab initio*."

In the instant case defendants, relying on the quorum provisions of the Fund's by-laws as authority for the minority directors' business judgment, have attempted a backdoor immunization in clear contravention of the policy embodied in Section 17(h).

In *Chabot* v. *Empire Trust Co.*, 301 F.2d 458, 461 (2d Cir. 1962) the Second Circuit had before it a clause in a trust agreement requiring shareholders to post security for litigation costs and expenses. In holding the provision violative of Section 17(h) because it protected the directors, the court said, "[i]t is our view that any provision that renders litigation substantially less likely 'protects or purports to protect' directors and officers from liability under the Act."

Here, the defendants do not seek to render litigation less likely; they seek to render it nonexistent.

The court in *Chabot* rejected defendants' argument that the security-for-cost provision was necessary to protect the fund, and ultimately the shareholders, from the expense of defending frivolous actions, noting

> [S]tockholder actions provide that "adequate independent scrutiny" of investment companies to which the Act refers,* and thereby tend to deter violations of the Act and of the common law duties of such companies. By the enactment of §17(h) Congress has expressed its judgment that the latter is the weightier concern—that unscrupulous management presents a greater danger to the financial interests of the shareholders than

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* The reference is to Section 1(b)(5).

> do unfounded shareholder actions. It is not for this court to reweigh that judgment.

Id. at 462.

In *Levitt* v. *Johnson*, 334 F.2d 815, 820 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965), the First Circuit refused to allow a state law requirement for a demand on shareholders to frustrate the enforcement of federal rights arising out of the Investment Company Act. Citing the declaration of national policy set forth in Section 1(b) of the Act, the court said, "[w]e believe a rule under which a demand upon the majority stockholders is a condition that cannot be excused in a case such as this is the type of hurdle the Investment Company Act . . . forbids."

The strong policy of the Investment Company Act leads to the conclusion that shareholder review of improper board action should not be abated by the maneuvering attempted in this case.

B. *The Powers Conferred on Disinterested Directors of Mutual Funds Do Not Include the Extraordinary Power to Terminate Validly Commenced Derivative Litigation.*

The Court of Appeals concluded that the minority directors of the Fund lacked the power to terminate this action. This determination was based upon an analysis of the Act.* To understand the basis of this conclusion, it is necessary to explore the nature and purpose of the statutory role conferred on disinterested directors by the Act and the unique structure of the mutual fund industry.

It has been universally recognized that mutual funds are little more than corporate shells, organized, staffed,

* The Court found it unnecessary to reach the question of whether minority directors of an ordinary business corporation possessed such power (A. 48 n.14). As will be shown, they do not (*infra*, Point II).

equipped, managed and controlled by an external investment adviser, whose primary objective is the maximization of its own profits.

> Because of the unique structure of this industry the relationship between mutual funds and their investment adviser is not the same as that usually existing . . . in conventional corporate relationships. Since a typical fund is organized by its investment adviser which provides it with almost all management services and because its shares are bought by investors who rely on that service, a mutual fund cannot, as a practical matter sever its relationship with the adviser. Therefore, the forces of arms-length bargaining do not work in the mutual fund industry in the same manner as they do in other sectors of the American economy.

S. Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4901. "[O]pen-end investment companies are typically legal shells without genuine autonomy, controlled by external management interests." Wharton School of Finance & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 67 (1962) (footnote omitted). "Mutual funds are formed by persons who hope to profit from providing management services to them. Realization of these expectations can best be assured if the funds remain under the effective control of their advisers." Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 127 (1966).

> A mutual fund is a "mere shell," a pool of assets consisting mostly of a portfolio of securities that belongs to the individual investors holding shares in the fund. The management of this asset pool is largely in the hands of an investment adviser, an independent entity

> which generally organizes the fund and provides it with investment advice, management services, and office space and staff. . . .
>
> This management structure contrasts sharply with that of a typical corporation. In the usual corporate situation, the interests of management and shareholders are identical on most matters. Since the officers who run the corporation are paid directly by the corporation and usually have a substantial equity investment in it, they devote themselves to profit maximization and thus act in the best interests of both the corporation and themselves. Control of a mutual fund, however, lies largely in the hands of the investment adviser, an external business entity whose primary interest is undeniably the maximization of its own profits.

Tannenbaum v. *Zeller,* 552 F.2d 402, 405 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977).

Because management of a fund is in the hands of an external adviser, conflicts of interest between the adviser and mutual fund shareholders are common. They are the order of the day. "The relationship between investment advisers and mutual funds is fraught with potential conflicts of interest. . . . Compensation for these services is determined under an advisory contract, the terms of which are all too often dictated to unwary or negligent fund directors and fund shareholders by the investment adviser." *Galfand* v. *Chestnutt,* 545 F.2d 807, 808 (2d Cir. 1976). "[S]elf-dealing is not the exception but, so far as management is concerned, the order of the day." *Moses* v. *Burgin,* 445 F.2d 369, 376 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971).

Because of the serious conflicts of interest often arising between advisers and fund shareholders, Congress provided in the Investment Company Act that at least forty per-

cent of a mutual fund's board of directors must be comprised of outside, or so-called disinterested, directors (Section 10(a), 15 U.S.C. §80a-10(a)). Where the adviser also is the principal underwriter, as in the present case, a majority of the fund's board must be comprised of disinterested directors (Section 10(b)(2), 15 U.S.C. §80a-10 (b)(2)).*

The primary function of the disinterested directors is to represent shareholder interests and act as "watchdogs" on their behalf in guarding against managerial abuses. *Tannenbaum* v. *Zeller,* 552 F.2d 402, 406 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977).

Thus, Section 15(c), 15 U.S.C. § 80a-15(c), of the Act imposes on disinterested directors a duty to review and approve the contracts of the investment adviser and principal underwriter. Approval of these contracts, in turn, is subject to a shareholder's right of judicial review under Section 36(b), 15 U.S.C. § 80a-35(b), notwithstanding the business judgment of the disinterested directors.

Section 16(b), 15 U.S.C. § 80a-16(b), of the Act requires that a majority of the disinterested directors nominate other disinterested directors to fill vacancies occurring upon an assignment of the advisory contract. Such nominees must then be elected by the shareholders.

Section 32(a), 15 U.S.C. § 80a-31(a), requires that a majority of the disinterested directors select a public accountant. Again, the selection must then be submitted to shareholders for their approval.

In these situations, where special responsibility is vested in the independent directors, they nonetheless lack ultimate decision making power, which is vested in the shareholders.

* In the present case, since two of the disinterested directors are defendants in the action, the remaining disinterested directors comprised only a minority of the board.

Probably the most important of the above duties assigned to disinterested directors under the Investment Company Act is the approval of the investment adviser's and principal underwriter's contracts under Section 15(c). Congress' rationale for providing a shareholder's right of action under Section 36(b) for judicial review of payments made pursuant to these contracts, even though approved by the independent directors, is of compelling applicability here. The Senate Report recommending passage of the 1970 amendments to the Investment Company Act found that disinterested direcors of mutual funds had no real independence from the adviser, as a practical matter could not sever the relationship between the fund and the adviser, and hence lacked any bargaining power in negotiating the adviser's fees. S. Rep. No. 91-184, 91st Cong., 2d Sess., *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4901. *See also* Securities and Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 131 (1966). Congress concluded that the disinterested directors were not sufficiently independent to protect shareholder interests in this regard. As stated in *Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975)

> It thus appears that in enacting Section 36(b) Congress assumed that the directors of the investment company would be antagonistic toward, and unlikely to prosecute, an action against the Fund's advisors for breach of fiduciary duty with respect to the receipt of compensation. In the instant case, the Fund admits its opposition to the lawsuit and argues that a decision of its board not to prosecute the action would be conclusive, thus precluding a shareholder from asserting the claims derivatively. While this rule might be appropriate in other kinds of derivative actions, its application in this context would clearly thwart the purpose of Congress in enacting Section 36(b) since a majority of the board of an investment company is rarely composed of "interested persons" and tangible indications of bias on the part of the unaffiliated majority are rarely present. As stated in the legislative history, control of a mutual fund by its advisor is the result of intangible factors arising out of the unique structure of the industry.

If disinterested directors of a mutual fund, even where they constitute a majority of the board, are statutorily presumed to lack sufficient independence to act dispositively for the shareholders in a suit against the adviser for excessive fees, how can a minority of disinterested directors be deemed competent to terminate a validly commenced nonfrivolous action against the adviser for gross misconduct and gross abuse of trust involving substantially more millions of dollars? The declaration of national policy in Section 1(b) of the Act prohibits any such result.*

As previously indicated, Section 17 of the Act precludes disinterested directors from authorizing or ratifying vari-

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* Defendants erroneously argue that the Court of Appeals imputed the right of a shareholder to sue under Section 36(b) into Section 36(a), 15 U.S.C. 80a-35(a). Plaintiffs' right to bring this suit is based on neither section. The issue addressed by the Court of Appeals was whether the minority directors had the extraordinary power to terminate a shareholder action properly brought. The Court of Appeals said in this respect

> It would surely be anomalous to hold that the statutorily disinterested directors could determine not to pursue litigation against their co-directors for liability which may amount to many millions of dollars, and foreclose the stockholders from *continuing* such litigation, while at the same time stockholders by statute are empowered to recover excess fees paid the adviser and underwriter.

A. 46 (emphasis added).

ous insider transactions, regardless of disclosure, fairness or reasonableness.* Under Section 17(b) such transactions must be submitted in advance to the SEC, which may grant an exemption only if it finds the transaction to be fair, reasonable, without overreaching and consistent with the policies of the Investment Company Act itself.

Thus, if disinterested directors are precluded by the statute from even acting upon transactions in which insiders are personally interested, again, how can they be deemed judicially competent, consistent with the purposes of the Act, to absolve summarily the same persons from millions of dollars in personal liability as they have attempted to do here? Clearly they cannot.

Congress intended that disinterested directors serve the shareholders as protectors of their interests. In the present case, in the name of protection, a minority of such directors sought to frustrate, to the extent of millions of dollars, the entitlement of those whose interests they are supposed to champion and defend. It is a use and abuse of power Congress never intended. Congress mandated that mutual funds be operated and managed for the benefit of the shareholders, not for the benefit of those who manage them. Consistent with that congressional policy, plaintiffs must be given the opportunity to prosecute their claims of managerial abuse.

Defendants' assertion that the 1970 amendments to the Act point to an opposite result is erroneous. The Senate Report recommending passage makes it crystal clear that the purpose of the amendments was to expand the basis for liability of investment company directors and advisers and to increase judicial scrutiny of their activities generally, not only as regards management fees. Thus the

* *Compare* Del. Code tit. 8, §144 (1975).

Report states that mutual fund directors "will continue to have overall fiduciary duties . . . for the supervision of all the affairs of the fund." S. Rep. No. 91-184, *reprinted in* [1970] U.S. Code Cong. & Ad. News 4897, 4902-03. In this connection the standard for fiduciary liability was broadened by Section 36(a) to give the "courts" greater "ability . . . to deal flexibly and adequately with wrongdoing" (*id.* at 4931).

While the 1970 amendments strengthen the role of the independent directors vis-à-vis the adviser in certain respects, it is clear that Congress did not intend to diminish shareholder access to the courts to enforce violations of the Act nor to confer upon the independent directors the extraordinary power which defendants would attribute to them.

There is nothing inconsistent between strengthening the role of independent directors and the judicial enforcement of fiduciary standards. Chairman Williams of the Securities and Exchange Commission made this point recently when he told the Investment Company Institute on May 17, 1978 that

> The Investment Company Act exists to exert a force to counter the strong conflicts of interest inherent in the mutual fund structure. Heretofore, that force has been embodied by the Commission staff, i.e., it has been an external force. Unfortunately, as I have said, this external force has worked its way deeply into internal matters. It is now time for appropriate internal forces to be brought to bear. I believe that the independent directors, supported and prodded where necessary by an appropriate internal structure, by the courts and by the Commission, are the appropriate source of that force.

Williams, *A Challenge to Mutual Funds,* SEC News Release, May 17, 1978, p. 8.

Here, the Court of Appeals' decision clearly recognizes and supports the role of the courts as contemplated by Chairman Williams.* The Court of Appeals was entirely correct when it held

* In the same address, Chairman Williams specifically rejected claims similar to those asserted here by defendants and the *amici curiae* that the decision of the Court of Appeals unduly restricted the powers and responsibilities of independent directors:

> Before moving on I should refer to another case which some have read as limiting the role of independent directors—namely *Lasker* v. *Burks* [CCH Fed. Sec. L. Rep. ¶96,282 (C.A. 2, 1978)]. As you know, in that case the Second Circuit found that the disinterested directors of a mutual fund could not effectuate the dismissal of a nonfrivolous derivative action against the fund's majority directors for breach of fiduciary duty. I do not believe that *Lasker* v. *Burks* should be read as restricting the responsibilities or the powers of independent directors. I believe the message is that substance will be considered over form, particularly in the unique circumstances presented by that case. The court found it was, for the benefit of those of you who have not read the opinion, ". . . asking too much of human nature to expect that the disinterested directors will view with the necessary objectivities the actions of their colleagues" when the independent directors are nominated by the majority directors, when their continued status depends on having satisfactory working arrangements with the majority directors, when management selects special counsel for the disinterested directors and when the majority directors face considerable personal liability in the event of an adverse decision.
>
> Moreover, the court was, obviously, very reluctant to raise any barriers to the statutory right of shareholders to sue under the Act for breaches of fiduciary duty. This latter consideration would not apply in ordinary cases involving the exercise of substantive business judgments. One may suspect that the court viewed the role of the independent director as being a check on management—not on the fund's shareholders.
>
> Nevertheless, a question which seems to pervade *Lasker* v. *Burks* is whether the directors there could be deemed truly independent. That question may legitimately be raised whenever directors are or appear to be more independent in form than they are in substance.

Id. at 12.

> **We see nothing in the findings of Congress, the legislation regulating investment companies and their advisers, or in the decisions of the courts which suggests that under such circumstances disinterested directors, such as the five who acted here, have the power to terminate litigation brought by mutual fund stockholders against the fund's investment adviser and its majority directors for breach of their fiduciary duties. On the contrary, the findings of Congress, the statutory scheme, and the relevant case law persuade us that the statutorily disinterested directors of a registered investment company were never meant to have the final word in determining whether it is in the best interest of a mutual fund to press claims against their co-directors, and the adviser with which those directors are affiliated, for breach of fiduciary duties.**
>
> . . .
>
> . . . It is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned. Correspondingly, it cannot be expected that the public or the Fund's stockholders would believe that these five statutorily disinterested directors could act with that impartiality and objectivity which the public interest requires. It follows that disinterested directors of an investment company do not have the power to foreclose the continuation of non-

frivolous litigation brought by shareholders against majority directors for breach of their fiduciary duties.

A. 43, 47 (footnote omitted).*

POINT II

A Minority of Directors Has Neither Power Nor Standing to Request the Termination of Nonfrivolous, Properly Commenced Derivative Litigation.

Defendants do not question the fact that this action has been properly commenced and that the demand requirements of Rule 23.1 have been fulfilled.** We know of no case where a validly commenced, nonfrivolous derivative action has been dismissed at the behest of a minority of a board of directors.

* The concern expressed by defendants that the decision of the Court of Appeals somehow places mutual fund directors in a disadvantageous situation vis-à-vis other corporate directors is ill-founded. As In re Kauffman Mutual Fund Actions, 479 F.2d 257 (1st Cir.), *cert. denied,* 414 U.S. 857 (1973) demonstrates, a board having a disinterested majority of directors has the same power that directors of ordinary corporations have to prevent a derivative suit under the demand rule. What is sought here is not equality of treatment but favored treatment. As is shown *infra,* Point II, no case has ever permitted a minority to stand in the way of derivative litigation. Yet, that is what this Court is requested to sanction. See Bernstein, *An Extension of Business-Judgment 'Cloak',* N.Y. Law J., Mar. 28, 1977, at 1, col. 1, in which the author criticized an attempt similar to that used by defendants before the District Court as an unwarranted extension of the business judgment rule, not as regards mutual funds, but with respect to business corporations generally.

** The District Court in its first opinion noted, "[n]o demand was made on the Fund's Board of Directors in this case because plaintiffs alleged (and it is not disputed) that the majority of the Fund's directors are charged with wrongdoing and as such a demand would be futile" (A. 15).

It is well settled that an independent minority, even if a quorum, cannot prevent the commencement of a derivative action by asserting that a demand should have been made so that the minority could exercise its "business judgment." The uniform rule is that demand is excused whenever a majority of a board is charged with wrongdoing or is subject to the control of the alleged wrongdoer.*

The clear meaning of this well settled doctrine is that minority directors have no corporate power or authority to prevent or halt derivative litigation.

If sanctioned by this Court, the contrived procedure adopted in the present case by the Fund's board would unsettle the whole doctrine of shareholder demand and excuse therefrom. The purpose of the judicially-evolved criteria for excusing demand, which itself establishes that a board is disqualified from exercising business judgment, would be rendered meaningless. A shareholder who successfully pleaded futility of demand by virtue of a wrongdoing majority could enter the courthouse one day only to find himself turned out the next by a minority of the same board. This would accord defendants an escape hatch the attractiveness of which would increase commensurately

* *See* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971); Levitt v. Johnson, 334 F.2d 815, 817 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965); Swanson v. Traer, 249 F.2d 854, 856, 858-59 (7th Cir. 1957); Jannes v. Microwave Communications, Inc., 57 F.R.D. 18, 21 (N.D. Ill. 1972); Barr v. Wackman, 36 N.Y.2d 371, 379, 368 N.Y.S.2d 497, 505 (1975); Hall v. M.B. O'Reilly Realty & Investment Co., 306 Mo. 182, 196, 267 S.W. 407, 411 (1924); Tillis v. Brown, 154 Ala. 403, 406-07, 45 So. 589, 590 (1908); Sohland v. Baker, 15 Del. Ch. 431, 441, 141 A. 277, 281-82 (1927); Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit,* 73 Harv. L. Rev. 746, 747 (1960).

with the seriousness and substantially of their exposure to liability.

Thus, a wrongdoing majority could easily provide for the existence of independent directors, without ever losing control over the board. This is particularly so in controlled corporations, such as investment companies, where "[t]he power to place a slate of directors before the shareholders through the proxy mechanism is tantamount to appointment." Nutt, *A Study of Mutual Fund Independent Directors,* 120 U. Pa. L. Rev. 179, 215-16 (1971) (footnotes omitted). Defendant or affiliated directors could be rotated out of office until independent directors perceived as sympathetic became available to exercise business judgment. The potential for abuse would be enormous.

> The court should not cajole itself into believing that the members of a Board of Directors elected by the dominant and accused majority stockholder after accusations of wrongdoing have been made, were selected for membership on the Board to protect the interests of the minority stockholders and to assure a vigorous prosecution of effective litigation against the offending majority.

Cohen v. *Industrial Finance Corp.*, 44 F.Supp. 491, 494 (S.D.N.Y. 1942). *See also Meltzer* v. *Atlantic Research Corp.*, 330 F.2d 946, 949 (4th Cir.), *cert. denied,* 379 U.S. 841 (1964).*

* In the present case all members of the minority quorum were selected by defendants and became directors after the Fund's board (including the wrongdoers) had decided to defer consideration of what action, if any, should be taken against Anchor and others until after the Fund's suit against Goldman, Sachs was concluded (A. 157; Doc 10, Phillips Affid. § 7, June 19, 1973).

The procedure approved by the District Court would place impossible burdens on shareholders seeking to prevent dismissal of derivative actions by minority directors. As a practical matter, it would be almost impossible to ferret out unspoken loyalties and biases which motivated the decision of the directors vis-à-vis their majority colleagues. Particularly in the mutual fund industry, "tangible indications of bias on the part of the unaffiliated majority [here, minority] are rarely present. As stated in the legislative history, control of a mutual fund is the result of intangible factors arising out of the unique structure of the industry." *Boyko* v. *Reserve Fund, Inc.*, 68 F.R.D. 692, 696 (S.D.N.Y. 1975).

This Court has repeatedly observed: "'"The objection . . . rests in their tendency, not in what was done in the particular case . . . . The Court will not inquire what was done. If that should be improper, it probably would be hidden and would not appear."'" *SEC* v. *Capital Gains Research Bureau,* 375 U.S. 180, 196 n.50 (1963). If the procedure permitted by the District Court is sanctioned, the way will have been found for the destruction of shareholder redress of insider abuses.

A recent decision of the First Circuit illustrates the interrelationship of the principles discussed above. In *Untermeyer* v. *Fidelity Daily Income Trust,* 580 F.2d 22 (1st Cir. 1978) a derivative action was commenced on behalf of a mutual fund. The board consisted of four persons, two of whom were principals of the defendant investment adviser and two of whom were statutorily disinterested. The fund sought to dismiss the action for failure to comply with the demand requirements of Rule 23.1. In order to bolster their position, in a tactic similar to that employed here, the two disqualified directors stipulated that they would not vote on any demand to com-

mence an action made on the board by the shareholders. The court rejected this proposal, held that demand was excused and allowed the action to proceed.

Untermeyer proceeds upon the well established principle that a demand is required only where there is an independent majority. It rejects the notion that an independent minority can somehow be established and vested with the power of life and death over the law suit. It also rejects the correlative proposition that there should be an "extensive subjective inquiry" into the "independence" of the minority in favor of excusing demand in circumstances that are "identifiable, both promptly, and with some certainty and simplicity" (*id.* at 24).

The Second Circuit's ruling here provides such certainty: it simply prevents a minority from attempting to dismiss a derivative action whose commencement it could not have prevented.

The procedure attempted by the Fund's minority directors and rejected by the Court of Appeals is unprecedented. Cases cited by the defendants and the *amici curiae* are inapposite. Most involved the issue of shareholder demand and uphold the power of a board to act where the majority of directors are neither wrongdoers nor subject to the control of a wrongdoer. *E.g., United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917); *Corbus* v. *Alaska Treadwell Mining Co.*, 187 U.S. 455, 463 (1903); *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 274-75 (3d Cir. 1978); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 264 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Ash* v. *IBM*, 353 F.2d 491, 493 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Swanson* v. *Traer*, 249 F.2d 854, 858-59 (7th Cir. 1957); *Bernstein* v. *Mediobanca Banca di Credito*, 69 F.R.D. 592, 596 (S.D. N.Y. 1974); *Independent Investor Protective League* v.

Saunders, 64 F.R.D. 564 (E.D. Pa. 1974); *Corey* v. *Independent Ice Co.*, 207 F. 459 (D. Mass. 1913); *Findley* v. *Garrett*, 109 Cal. App. 2d 166, 176, 240 P.2d 421, 427 (2d Dist. 1952); *McKee* v. *Rogers*, 18 Del. Ch. 81, 156 A. 91 (1931).

Others involved the business judgment rule as an affirmative defense to charges of directorial misconduct and have nothing to do with a board determination regarding the termination of derivative actions. *E.g., Davis* v. *Louisville Gas & Elec. Co.*, 16 Del. Ch. 157, 168-71, 142 A. 654, 658-60 (1928); *Ella M. Kelly & Wyndham, Inc.* v. *Bell*, 266 A.2d 878 (Del. 1970); *Moskowitz* v. *Bantrell*, 41 Del. Ch. 177, 180-82, 190 A.2d 749, 750-51 (1963); *Beard* v. *Elster*, 39 Del. Ch. 153, 164-65, 160 A.2d 731, 738-39 (1960); and *Puma* v. *Marriott*, 283 A.2d 693 (Del. Ch. 1971).

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There is no basis for defendants' assertion that the minority directors could terminate this litigation. The applicable authorities are to the contrary.

POINT III

Delaware Law Does Not Permit the Tactic Adopted by Defendants. Also, the Federal Courts Have Refused to Allow State Procedural Devices to Stand in the Way of Enforcement of Federal Rights.

A. *Delaware Law*

The law in Delaware, as elsewhere, is that where a majority of the directors are alleged wrongdoers or where an action, if brought by the corporation itself, would be subject to the control of the alleged wrongdoers, a demand on the board is excused and a shareholder may prosecute the claim on behalf of the corporation. *See McKee* v. *Rogers*, 18 Del. Ch. 81, 85-86, 156 A. 191, 193 (1931);

Satterthwaite v. *Eastern Bankers Corp.*, 17 Del. Ch. 310, 312, 154 A. 475, 476 (1931); *Sohland* v. *Baker*, 15 Del. Ch. 431, 441, 141 A. 277, 281-82 (1927). As stated by the Supreme Court of Delaware, "[t]he settled practice in Delaware has been that demand upon and refusal by the directors is sufficient, or, if the directors are disqualified to give redress, demand would be futile and is excused." *Mayer* v. *Adams*, 37 Del. Ch. 298, 304, 141 A.2d 458, 462 (1958). Under Delaware law, the Fund's board was disqualified and the minority directors were therefore without authority to act.

Thus the Delaware precedents are the same as under Federal Rule 23.1. There is no rational basis for denying to a minority the right to prevent commencement of a derivative action and thereafter granting to it the right to terminate the very same action. The same policy reasons which preclude exercise of business discretion by a minority in the first instance similarly preclude its exercise in the second instance: it would be highly inappropriate to place effective control over litigation in the hands of a board of directors run by those most hostile to the litigation's success. *See Hall* v. *M.B. O'Reilly Realty & Investment Co.*, 306 Mo. 182, 196, 267 S.W. 407, 411 (1924); *Tillis* v. *Brown*, 154 Ala. 403, 406-07, 45 So. 589, 590 (1908).

It is also clear that under Delaware law a board of directors may not sanction or ratify the perpetration of fraudulent or illegal acts by co-fiduciaries, such as are alleged in the present case. "It is settled law in Delaware that if the acts are ultra vires, illegal or fraudulent they may not be ratified." *Toebelman* v. *Missouri-Kansas Pipe Line Co.*, 130 F.2d 1016, 1022 (3d Cir. 1942). *See also Bennett* v. *Propp*, 41 Del. Ch. 14, 24-25, 187 A.2d 405, 411 (1962); *Keenan* v. *Eshleman*, 23 Del. Ch. 234, 2 A.2d 904 (1938).

The minority directors' decision in the instant case to seek to abort further judicial consideration of this matter is tantamount to an impermissible ratification under Delaware law. In *Mayer* v. *Adams*, 37 Del. Ch. 298, 304, 141 A.2d 458, 461 (1958) the Delaware Supreme Court said

> [A] decision not to press a claim for alleged fraud committed by the directors means, in effect, that the wrong cannot be remedied. It is conceded that the wrong cannot be ratified by the majority stockholders, but it is said that refusal to sue is a different thing from ratification. Strictly speaking, this is true, but the practical result is the same.

The same view is held by other state courts. "[I]n our opinion, neither a board of directors nor a majority of stockholders can, by ratification, make valid that which the corporation itself is by law prohibited from doing; nor can such ratification be accomplished indirectly under the guise of a refusal to bring an action." *Siegman* v. *Electric Vehicle Co.*, 72 N.J. Eq. 403, 409, 65 A. 910, 912 (1907). *See also Fisher* v. *National Mortgage Loan Co.*, 132 Neb. 185, 198-99, 271 N.W. 433, 440-41 (1937); *Continental Securities Co.* v. *Belmont*, 206 N.Y. 7, 17-19 (1912).*

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* As stated in Note, *Demand on Directors and Shareholders as a Prerequisite to a Derivative Suit*, 73 Harv. L. Rev. 746, 762 (1960)

> [W]hen the shareholders or directors have refused a demand to sue on a nonratifiable wrong, the plaintiff should always be allowed to proceed. . . . [I]t seems clear that a state's statutory or decisional law which holds certain wrongs nonratifiable evinces a policy which means to give the minority shareholder the power to redress these wrongs after directors and majority shareholders have declined to do so. . . . It is one thing to insist upon giving the primarily responsible parties an opportunity of bringing a suit, but quite another to allow them to prevent one when the policy of the law denies them that power.

Federal decisions are to the same effect. *See Brody* v. *Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973); *Rogers* v. *American Can Co.*, 305 F.2d 297 (3d Cir. 1962); *Gottesman* v. *General Motors Corp.*, 268 F.2d 194, 197 (2d Cir. 1959).

In the instant case, the decision of the minority directors not to sue, if given effect, would not only constitute an improper ratification, but would also violate a strong Delaware policy favoring strict accountability of wrongdoing by corporate fiduciaries.

> The policy of the General Corporation law for many years has been to grant to the directors, and to the majority stockholders in certain matters, very broad powers to determine corporate management and policy. But, correlatively, the policy of our courts has always been to hold the directors and the majority stockholders to strict accountability for any breach of good faith in the exercise of these powers, and to permit any minority stockholders to seek redress in equity on behalf of the corporation for wrongs committed by the directors or by the majority stockholders.

Mayer v. *Adams,* 37 Del. Ch. 298, 304, 141 A.2d 458, 461 (1958).

Defendants have relied on the quorum provision of Delaware Corporation Law §141(b) and the Fund's by-laws as authority for the minority directors' decision to have this action dismissed. They now seek to add, for the first time, Delaware Corporation Law §144 as a source of legitimacy. Defendants cite no case law in connection with either provision suggesting the propriety of what

was done here.* There is no reason to believe that the Delaware courts would permit either provision to be used to alter strong Delaware policy concerning board disqualification in derivative suits, nonratification of fraud or illegality, and strict accountability by corporate fiduciaries for alleged wrongs. To the contrary

> [I]n situations in which a fiduciary duty is owed slavish compliance with a statutory requirement does not of itself make corporate actions immune from attack. . . .
>
> . . . [A] court of equity is duty-bound to protect the interests of stockholders when they are threatened and to enforce the duties of fiduciaries in situations in which allegations of wrongdoing are made.

In re Arthur Treacher's Fish & Chips of Ft. Lauderdale, Inc., 386 A.2d 1162, 1166-67 (Del. Ch. 1978). *See also Young* v. *Valhi, Inc.*, 382 A.2d 1372, 1378 (Del. Ch. 1978) (denouncing the "use of technically correct but devious corporate actions" to defeat the rights of minority stockholders); *Schnell* v. *Chris-Craft Indus., Inc.*, 285 A.2d 437 (Del. 1971).

It is therefore quite clear that defendants' procedural gambit is not permitted by Delaware corporate law.

B. *Federal Cases*

Federal courts have evinced a policy of guarding litigants who seek to enforce rights under the federal secu-

* In his treatise on Delaware corporate law, Professor Folk says with respect to Section 144 that "directors' actions are outside of the protection of the business judgment rule on finding 'fraud or gross abuse of discretion,'" as here alleged. E. L. FOLK, THE DELAWARE GENERAL CORPORATION LAW: A COMMENTARY AND ANALYSIS 76 (1972).

rities acts from being tossed out of court because of slavish adherence to procedural or technical niceties.

In *Drachman* v. *Harvey,* 453 F.2d 722, 728-30 (1971), *aff'd in relevant part upon rehearing in banc,* 453 F.2d 736 (2d Cir. 1972), defendants moved to dismiss a derivative action arising under Section 10(b) and Rule 10b-5 of the Securities Exchange Act on the grounds that neither Rule 23.1 nor the Exchange Act expressly conferred standing to sue upon shareholders whose stock was held in street name only, as opposed to registered owners. Defendants argued that the law of the state of incorporation, California, which permitted only registered owners to sue, should apply. The court of appeals refused to allow such technical arguments to defeat important federal regulatory policy and held that Federal Rule 23.1 standards, which afforded beneficial owners the right to sue, governed.

Drachman also clearly answers defendants' suggestion that Delaware law—which defendants have erroneously interpreted—can override or render nugatory important federal rights. *Drachman* counsels the opposite. The court noted

> The mission to protect completely and effectively the rights of the investing public under the Exchange Act cannot cease at the implication of a private right of action under §10(b) and Rule 10b-5. To permit diverse state law, reflecting conflicting or at least varying state policies, to define "who is a 'shareholder'" for purposes of a derivative action under §10(b) "would limit severely the scope of that section in an area comprehended by the statutory scheme," and in many cases might render a nullity the very right which federal law has sought to provide.

> . . . Congress scarcely would have intended such an incongruous result, given the comprehensive statutory remedial scheme of the Exchange Act passed for the protection of investors, nor would Congress have intended the creation of a broad remedial scheme, the effectiveness of which could be varied by the whims and vagaries of state law.

Id. at 729-30 (footnotes omitted). *See also In re Pittsburgh & Lake Erie Railroad Co. Securities & Antitrust Litigation,* 543 F.2d 1058 (3d Cir. 1976); *Meltzer* v. *Atlantic Research Corp.,* 330 F.2d 946, 948 (4th Cir. 1964), *cert. denied,* 379 U.S. 841 (1964); *McClure* v. *Borne Chemical Co.,* 292 F.2d 824, 831-35 (3d Cir.), *cert. denied,* 368 U.S. 939 (1961); *Fielding* v. *Allen,* 181 F.2d 163 (2d Cir. 1950).

The same result has been reached in cases arising under the Investment Company Act. In *Levitt* v. *Johnson,* 334 F.2d 815, 819 (1st Cir. 1964), *cert. denied,* 379 U.S. 961 (1965) the court held that a state law procedural requirement of demand on shareholders could not be used to prevent commencement of an action under the Act. The court said

> [T]he question is whether the act contemplated or impliedly forbade the application to the assertion of derivative rights of what the [district] court concluded to be a "strict Massachusetts rule." In this connection we note in section 1(b) a clear declaration of policy. The act is directed to "the national public interest and the interest of investors * * * adversely affected," and its "purposes * * * with which [its] provisions * * * shall be interpreted, are to mitigate and, *so far as is feasible, to eliminate* the conditions enumerated." (ital. suppl.) We do not see how it can be gainsaid that any substantial stiffening of the conditions precedent to

> the bringing of stockholders' suits above normal requirements would conflict with this broad declaration. The district court's reasoning that since the stockholder's right is a derivative one his right to bring suit must be controlled by the local law of the state of incorporation in the absence of an explicit congressional direction to the contrary negates the intendment of the act and underestimates the role to be played by the federal courts in the implementation of national regulatory legislation.

Id. (footnote omitted). *See also Rosenfeld* v. *Black*, 455 F.2d 1337, 1345 (2d Cir. 1971), *cert. denied*, 409 U.S. 802 (1972); *Chabot* v. *Empire Trust Co.*, 301 F.2d 458 (2d Cir. 1962).*

* * *

Neither Delaware law nor applicable federal considerations** permit the artifice attempted by defendants here.

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* Mr. Eisenberg, counsel in this case for the Investment Company Institute, has previously written with respect to the Investment Company Act, and Section 36 in particular, that "[s]hareholder rights in such a suit are based on federal law and should not be impeded by corporate or state devices designed to frustrate or unreasonably burden derivative suitors." Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 Rutgers Law Rev. 181, 225 (1966) (footnotes omitted).

** If state restrictions on derivative actions were given free rein, mutual funds could "shop" for friendly places in which to incorporate and then use state law restrictions to fend-off derivative claims. Surely the broad remedial purposes of the federal acts involved do not permit such "forum shopping."

POINT IV

The Procedure Urged by Defendants and Adopted by the District Court Violates the Requirements of Rule 23.1. There Is No Need to Adopt the Unduly Complex Formulation Proposed by the SEC.

A. *The Requirements of Rule 23.1*

Rule 23.1 of the Federal Rules of Civil Procedure promulgated by this Court states that a derivative action "shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

It is well settled that judicial approval of the dismissal or compromise of a derivative action must be based upon a full exploration of the relevant circumstances, including the merits of the action. Generally, there must have been discovery on the merits. *See Saylor* v. *Lindsley*, 456 F.2d 896, 904-05 (2d Cir. 1972); *Weiss* v. *Chalker*, 55 F.R.D. 168, 169 (S.D.N.Y. 1972). The court must weigh the strength of plaintiff's claims and probability of success on the merits. *See Fricke* v. *Daylin, Inc.*, 66 F.R.D. 90, 97 (E.D.N.Y. 1975); *Cannon* v. *Texas Gulf Sulphur Co.*, 55 F.R.D. 308, 315-16 (S.D.N.Y. 1972). The court must then make an independent decision as to whether termination is fair and adequate to all concerned, including the absent shareholders on whose behalf the action has also been brought. *See Norman* v. *McKee*, 431 F.2d 769, 774 (9th Cir. 1970), *cert. denied*, 401 U.S. 912 (1971).* Defendants would ignore these funda-

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* Consistent with these criteria, Judge Fuld indicated in his report to the Fund's board, "[i]f . . . the Fund were actively to seek dismissal of the suit, current court procedures would appear to require a hearing substantially on its merits" (A. 111). Judge Fuld in his supplemental report modified this position slightly by

mental precepts of fairness by hiding behind the cloak of the business judgment rule.

Even in the few instances where a subsequently constituted independent majority has sought dismissal, the courts have uniformly refused to act as rubber stamps. Rather, in each instance, the court has carefully scrutinized the proposed "business judgment" of the new majority and then made its own independent determination based upon an evaluation of the merits of the action and the over-all fairness of the proposed action.

In *Birnbaum* v. *Birrell*, 17 F.R.D. 409 (S.D.N.Y. 1955) a derivative action had been commenced on behalf of Universal Labs, Inc. After commencement of the action, a new and concededly independent board of directors was seated. That new board, whose members controlled 62 percent of the stock, and the plaintiff reached a settlement with the wrongdoing defendants and applied to the court for dismissal pursuant to old Rule 23(c). Certain shareholders objected.

saying that "at a minimum, the court would review the reasons for seeking dismissal and might consider, at least to some degree, the underlying merits of the derivative action" (A. 116). Defendants' took a contrary position below, arguing that Rule 23.1 was inapplicable and judicial evaluation of the merits unnecessary because the dismissal of this case was "involuntary." In support of this proposition, defendants cited cases involving the involuntary termination of derivative actions solely by operation of law. These cases are totally inapposite. *See* Katz v. Aspinwall, 342 F. Supp. 286 (N.D. Ala. 1971), *aff'd*, 459 F.2d 1045 (5th Cir.), *cert. denied*, 409 U.S. 1000 (1972) (suit dismissed because of dissolution of corporation); Daugherty v. Ball, 43 F.R.D. 329, 335 (C.D. Cal. 1967) (suit dismissed because corporation did not survive a merger); Marcus v. Textile Banking Co., 38 F.R.D. 185, 186 (S.D.N.Y. 1965) (suit dismissed as to defendant with respect to whom court lacked personal jurisdiction). Unlike the cited cases, defendants here seek dismissal based on the allegedly voluntary act of the minority directors as the purported representatives of the Fund.

Judge Edelstein refused to approve the settlement. Rather, he first directed that adequate notice be given to the stockholders and further directed that hearings be held as to the propriety of the settlement, including the adequacy of the settlement, the absence of collusion and the merits of the action. The court specifically rejected the notion that approval by the new board obviated the necessity of an appropriate hearing.

In *Berger* v. *Dyson*, 111 F.Supp. 533 (D.R.I. 1953) a settlement of a derivative action was proposed to the court. Substantial changes in the board had resulted in a quorum consisting of non-wrongdoers. Those new directors supported the proposed settlement. The court found it necessary to fully review the proposed settlement, including the merits of the action, before it would approve it. Concededly, the court believed that the board approval was a factor which it should consider. But it expressly rejected the position urged by defendants here: that the board determination was conclusive.

In *Denicke* v. *Anglo California Nat'l Bank*, 45 F.Supp. 524 (N.D. Cal. 1942), *aff'd*, 141 F.2d 285 (9th Cir.), *cert. denied*, 323 U.S. 739 (1944) a proposed compromise of derivative actions was before the courts. A change in management had occurred and no defendant was on the board at the time the compromise was proposed.

The courts nonetheless would not approve the settlement until there had been extensive hearings on all aspects of the proposed settlement and a careful consideration of the probability of success. The case is all the more significant because the board's approval of the settlement had been put to the stockholders, all of whom, except the two plaintiffs, had approved. Even this approval did not impel the courts to abdicate their judicial function.

In *Syracuse Television, Inc.* v. *Channel 9, Syracuse, Inc.*, 28 App. Div. 2d 638, 280 N.Y.S.2d 287 (4th Dep't 1967) a unanimous five judge court refused to permit a majority of directors and shareholders to end on-going derivative litigation despite their claim that they were acting reasonably, in good faith and with full knowledge of the facts. The Appellate Division stated that

> The allegations of the complaint of breach of duties imposed on officers and directors . . . merit a full and plenary trial and the issues should not be limited to whether the stockholders and directors ratified the actions of the defendants and voted to discontinue suits in good faith and with full knowledge of the facts.

In *Wolf* v. *Barkes*, 348 F.2d 994 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965), plaintiff had commenced a derivative action challenging the compensation arrangements of four corporate employees. After commencement of the action, the four employees resigned and a proposed settlement was arrived at. The plaintiff sought to enjoin consummation of the settlement. No application for judicial approval of the settlement was before the court.

The court did not enjoin the board from proceeding but noted that all concerned proceeded at their own risk. The Second Circuit was also careful to point out that any request for judicial approval of the proposed settlement would require the usual, then Rule 23(c), hearing. The court's analysis of the *Denicke* and *Birbaum* cases is significant.

> In Denicke v. Anglo California Nat'l Bank, 141 F.2d 285 (9 Cir.), cert. denied, 323 U.S. 739, 65 S.Ct. 44, 89 L.Ed. 592 (1944), the corporation, which had come under new management, sought and obtained approval of a compromise under rule 23(c); so far as the case has any pertinence, this is only for its implicit holding that when a derivative suit is compromised in a district court, rule 23(c) must be complied with although the settlement has been instigated not by the derivative plaintiff but by the corporation acting under an independent board of directors. The same implicit holding appears in Birnbaum v. Birrell, 17 F.R.D. 409 (S.D.N.Y. 1955).

Id. at 997.

The cited cases amply demonstrate that even an independent majority of the board does not possess the raw power to dismiss a derivative action and that a full hearing, with all of its ancillary safeguards, is required. *See also* 3B Moore, Federal Practice §23.1.24[2] at p. 23.1-138.

We have found no decision prior to that of the District Court herein in which a minority of a board even attempted to dictate the dismissal of a validity commenced derivative action.*

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* Defendants have cited a number of cases (Pet. Br. 25n.) in support of their assertion that a minority of directors can terminate derivative litigation. These cases are inapposite. In Goodwin v. Castleton, 19 Wash.2d 748, 144 P.2d 725 (1944) a disinterested majority of directors and the shareholders approved a settlement, following which the court held a two-week trial before giving its approval. Alleghany Corp. v. Kirby, 344 F.2d 571 (2d Cir. 1965) was not a derivative action, but a direct action by the corporation. Two previously uninvolved shareholders attempted to compel the corporation to petition for a writ of *certiorari* from an adverse decision before the Court of Appeals. Their attempted intervention was held untimely. And in Brody v. Chemical Bank, 517 F.2d 932 (2d Cir. 1975) the filing of an amended complaint after an entirely new board had been appointed by court order was held to trigger a new demand requirement. In that case, unlike the case at bar, no board member was a defendant and there was no close relationship between the defendant and the "independent" directors. As we have shown, *Wolf* v. *Barkes*, *supra*, pp. 46-47 does not support defendants' but lends strong support to plaintiffs' position.

Following the District Court's decision in the present case, there have been two reported cases in which attempts were made to curtail derivative litigation under the imprimatur of business judgment exercised by a purportedly independent committee of minority directors advised by special counsel.

In *Gall* v. *Exxon,* 418 F.Supp. 508, 518 (S.D.N.Y. 1976) the court, noting that (unlike this case) there was not the slightest evidence of merit to plaintiff's claims, approved a procedure similar to the one here employed. The decision was rendered prior to the reversal by the Second Circuit in this case and was not appealed.

In *Auerbach* v. *Bennett,* 64 App. Div. 2d 98, 408 N.Y.S.2d 83 (2d Dep't 1978) a derivative action was commenced involving alleged improper bribes and kickbacks. After commencement of the action, three independent directors (a minority) were appointed to a Special Litigation Committee. Former Chief Judge Desmond of New York was retained and rendered a report in which he concluded that the derivative claims were without merit and that in any event it was not in the best interests of the corporation to prosecute the action. A motion for summary judgment was thereupon interposed by the corporation. At that time, there had been no discovery in the action.

In reversing dismissal of the action, a unanimous court refused to permit dismissal prior to the completion of pretrial discovery. The court rejected the notion "that the contours of the business judgment doctrine have been matched by the report of the committee and no further inquiry by an aggrieved stockholder should be entertained" (*id.* at 107, 408 N.Y.S.2d at 87). In this regard, the court first noted that "the hesitancy which might arise in outside directors by their investigation of fellow directors, especially when personal liability is at stake, is a consideration of moment" and then stated

> The business judgment doctrine should not be interpreted to stifle legitimate scrutiny by stockholders of decisions of management which, concededly, require investigation by outside directors and present ostensible situations of conflict of interest. Nor should the report of the outside directors be immune from scrutiny by an interpretation of the doctrine which compels the acceptance of the findings of the report on their face. In particular, summary judgment which ends a derivative action at the threshold, before the plaintiff had been afforded the opportunity of pretrial discovery and examination before trial, should not be the means of foreclosing a nonfrivolous action (*Lasker* v. *Burks,* 567 F.2d 1208). The limitation on the use of summary judgment, that it should not be granted when the facts are peculiarly within the knowledge of the moving party, applies with special force here. . . .

Id. at 107-08, 408 N.Y.S.2d at 88 (footnote omitted).

The court specifically approved the rationale of the Second Circuit in this case, rejected the argument that the decision was applicable only to investment companies and held that it was equally applicable to directors of ordinary business corporations (*id.* at 108 n.6, 408 N.Y.S.2d at 88 n.6).

The court concluded

> In short, the business judgment rule should not be so rigorously applied as to cut short practically at the pleading stage an apparently legitimate inquiry into a nonfrivolous claim of wrongdoing by directors and officers on the ground that a committee of disinterested directors, acting on the advice of independent counsel,

decided that the corporate interests will not be promoted by a derivative action.

Id. at 108, 408 N.Y.S.2d at 88.

Auerbach clearly stands for the propositions (a) that minority directors lack the naked power to terminate on-going derivative actions; (b) that discovery is required to elucidate all of the facts, including the merits; and (c) that full judicial inquiry is required.*

It is therefore apparent that dismissal of a properly commenced derivative action requires consideration of the relevant factors pursuant to Rule 23.1. As is shown in Point V, even if a hearing had been held in the present case, relevant considerations would require that this action be permitted to continue.

B. *The SEC's Proposal Should Not Be Adopted*

The well charted course offered by Rule 23.1 demonstrates that there is no need to adopt the SEC's complex proposal. That proposal would wreak havoc with the traditional role of the courts in derivative litigations; it would also result in extensive, time-consuming and litigation-delaying hearings at the behest of minority directors.**

* A similar result is indicated by Elgin Nat. Indus., Inc. v. Zale Corp., 71 Misc.2d 468, 336 N.Y.S.2d 275 (Sup. Ct. 1972). There a derivative action was brought on behalf of Elgin. Thereafter, the court permitted Elgin to take over the action based upon a finding that the corporation was controlled by independent directors. Those independent directors then sought to discontinue the action. The court directed that appropriate notice be sent to all stockholders and that a formal judicial hearing be held because "the action should [not] be discontinued without affording the stockholders the opportunity to further investigate the merits and to present any testimony they wish to present on the issue of discontinuance" (71 Misc.2d at 470, 336 N.Y.S.2d at 277).

** The SEC has also argued that two of the three prongs of its impractical test have been satisfied (SEC Br. 23-4). This erroneous contention will be dealt with in Point V.

The SEC's proposal is based upon a number of ill-conceived and misconceived notions:

1. A basic premise of the SEC's position is that, generally speaking, corporate boards possess the absolute power to terminate on-going derivative litigation. As has been shown, this fundamental premise is incorrect.

2. The SEC's test of "business judgment" would revolve solely upon the information before the board at the time of its decision. There is nothing in the SEC's test to assure that adequate—or even honest—information would be supplied to the board.*

3. The SEC suggests a review standard with respect to board action similar to that when administrative action is judicially reviewed. Nowhere, however, does the SEC provide for any mechanism to afford the plaintiffs the safeguards guaranteed by the Administrative Procedure Act: (a) impartial arbiters of the facts—not handpicked individuals paid by, subservient to, or subject to removal by the wrongdoers (*see Commonwealth Coatings Corp.* v. *Continental Casualty Corp.*, 393 U.S. 145 (1968), *reh. denied*, 393 U.S. 1112 (1969)); (b) due notice to plaintiffs of the scope of the inquiry—not notice contained in papers moving to dismiss; and (c) the right to call witnesses and present evidence—not a limited inquiry which prevents all discovery on the merits.

4. The notion that the hearing before the court should be akin to review of administrative determinations also

* Thus, in the present case there is no indication that the information given to Judge Fuld or the minority directors was given under oath (A. 82). There also is no way for plaintiffs to ascertain whether defendants withheld information. How can adequacy of disclosure possibly be tested without the safeguards of sworn testimony taken in an adversary context?

overlooks the fact that the courts, not directors or their counsel, are uniquely qualified to determine the validity of claims asserted in a litigation. *Marx & Co.* v. *Diners Club, Inc.*, 550 F.2d 505, 509-12 (2d Cir.), *cert. denied*, 434 U.S. 861 (1977).

Further, in derivative suits the court is charged with a duty to protect the interests of absent shareholders. That responsibility cannot be delegated to the selected representatives of the wrongdoing defendants.

Heretofore, the demand and futility criteria in Rule 23.1 have been used by the courts to determine on the pleadings whether or not a board of directors is competent to exercise business judgment with respect to the wrongs alleged. *See Untermeyer* v. *Fidelity Daily Income Trust*, 580 F.2d 22, 24 (1st Cir. 1978); *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Papilsky* v. *Berndt*, 59 F.R.D. 95, 98 (S.D.N.Y. 1973), *appeal dismissed*, 503 F.2d 554 (2d Cir.), *cert. denied*, 419 U.S. 1048 (1974). Under the SEC's proposed rule, that simple procedure for testing a board's competence at the threshold of litigation would be supplanted by a costly, burdensome and complex preliminary evidentiary inquiry into the Gordian issues of independence, adequacy of disclosure and reasonableness of the decision.*

The SEC's assertion that *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977) supports

* In the present case, for example, approximately 3½ years elapsed between the time the minority directors agreed to look into the matter and the reversal by the Court of Appeals. Approximately 1,000 pages of deposition testimony were taken. There were three adjudicated motions and opinions by the District Court, one appeal and a request for rehearing in banc all addressing the single issue of whether the minority directors were competent to dismiss this action. The time and cost factors have been enormous to all concerned, and defendants have not to this day answered the complaint.

the cumbersome preliminary procedure proposed here is without merit.

In *Tannenbaum*, as in *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the issue before the court was whether an investment adviser failed to make full and adequate disclosure to the independent directors regarding the possibility of recapturing brokerage commissions. Whether to recapture was a matter of business judgment and failure to recapture in and of itself did not constitute a violation of law. The gravamen of the offense charged in those cases was management's failure to disclose adequately to the independent directors information concerning the possibility of recapture.

As proposed in the *Tannenbaum* case, the SEC rule was intended to add a *more stringent test* than that afforded by the traditional business judgment rule. Thus, if defendants could prove the independent directors (i) were in fact independent, (ii) were fully informed, and (iii) made a reasonable decision not to recapture, they would be found innocent of the charge of nondisclosure. In these cases the merits of the litigation involved the adequacy of disclosure to the independent directors and presumably that matter would have been the subject of exploration by pretrial disclosure. Here, the SEC would prevent any testing of the adequacy of disclosure in the traditional litigative setting.

Fogel and *Tannenbaum* are concerned with determining whether directorial discretion has been properly exercised in areas where discretion is vested in the directors. Here, the complaint charges fraud and illegality. As stated in *Arthur Lipper Corp.* v. *SEC*, 547 F.2d 171, 179 (2d Cir. 1976), *cert. denied*, 434 U.S. 1009 (1978), "it is not within the competence of a board of directors of an investment

company to sanction the perpetration of a fraud by the manager. . . . Indeed, it would seem that only a unanimous shareholder vote could ratify a fraud of this type even if approved by directors" (citations omitted). This decision militates against adoption of the SEC's proposal. *See also Tannenbaum* v. *Zeller, supra,* 552 F.2d at 429 n.31; *Fogel* v. *Chestnutt, supra,* 533 F.2d at 750.

The SEC acknowledges in its brief that managers of financial institutions "are under an especially high standard of fiduciary care toward the money they manage" (SEC Br. 18n.13).* In utter perversion of this principle the SEC now seeks to hold such managers to a lesser standard of judicial review than is otherwise applicable under Rule 23.1. It seeks also to brush aside Congress' mandate that investment companies be operated for the benefit of the shareholders, not for the benefit of the directors or the investment adviser. The SEC's proposed rule would create a privileged managerial class, able, as was done here, to handpick its own judge and jury, the forum and manner of trial and the evidence to be produced for consideration. There is no parallel in our jurisprudence.

The SEC's suggested procedure is costly, burdensome, unnecessary and unfair. It would disrupt and supplant the operation of Rule 23.1 and would overrule, in principle, hundreds, if not thousands, of judicial decisions concerning the disqualification of boards of directors under similar circumstances.

No court would approve a dismissal of this case under Rule 23.1 at the instance of plaintiffs without a full inquiry. This Court should not permit its dismissal at the instance of defendants acting through handpicked minority

* See cases cited at pp. 66-67, *infra*.

directors. Reason, logic, the law and fairness require that the SEC's position not be adopted in the present case.*

POINT V

There Is No Need for Any Further Proceedings as to the "Propriety" of the Action of the Minority. An Examination of the Relevant Factors Conclusively Demonstrates That This Action Should Proceed and Be Litigated on the Merits.

Both Rule 23.1 and the SEC's proposed procedure call for an examination of various circumstances in order to permit a court to determine whether a derivative action should be dismissed.** An examination of the relevant factors in this case conclusively demonstrates that it cannot be dismissed because:

A. The minority quorum was not independent;

B. The action has merit;

C. The minority quorum was not fully and fairly informed of all relevant facts; and

D. Continued prosecution of the action cannot possibly injure the Fund.

This action was commenced in February 1973. There has been no discovery on the merits—indeed, defendants have not even answered. It is time that defendants face up to the merits.

* Rule 23.1 itself provides an adequate framework for the termination of suits in which continued litigation poses a threat of imminent harm to the corporation. In such cases the District Court can decide whether termination is fair and in the interests of the absent shareholders, as it does in all Rule 23.1 dismissals and compromises.

** As noted in Point IV, the defendants and the SEC would ignore the requirements of Rule 23.1 by preventing any discovery on the merits.

A. The Minority Quorum Was Not Independent

The evidence overwhelmingly establishes the lack of independence of the minority. They were chosen to serve on the boards of the Anchor Group of Mutual Funds by Anchor and the majority directors, who could have removed them at will. They were all selected after the events complained of here.* They also had personal relationships with one or more of the defendants. In addition, Anchor completely dominated the Fund at all levels of operation and occupied all strategic managerial positions. Under these circumstances, independence was impossible.

The following chart shows the composition of the Directors' Qualifications Committee, which screened and recommended each member of the disinterested quorum for nomination as a Fund director. As is evident, in every instance, except for the selection of Mr. Kendall, the Committee consisted totally of defendants. In Mr. Kendall's case, two of the three members of the Committee were defendants.

Minority Directors	*Initially Recommended By*	*Members of Directors Qualifications Committee*
1. Laun	Defendant Phillips	Defendant Haire Defendant Burks Defendant Phillips

* As we have indicated, at a board meeting held on October 28, 1970 the Fund directors decided to sue Goldman, Sachs and to defer any decision as to what action should be taken against Anchor and others (A. 157; Doc. 10, Phillips Affid. ¶7, June 19, 1973). Two of the minority were seated after that resolution and three more after commencement of this action in February 1973.

Minority Directors	*Initially Recommended By*	*Members of Directors Qualifications Committee*
2. O'Connor	Defendant Haire	Defendant Haire Defendant Burks Defendant Phillips
3. Stephens	Defendant Hopkins	Defendant Haire Defendant Kemmerer Defendant Hopkins
4. Robichaud	O'Connor, after prior approval by Defendant Haire	Defendant Haire Defendant Kemmerer Defendant Hopkins
5. Kendall	Defendant Haire	Defendant Haire Defendant Kemmerer Defendant Robichaud

(Doc. 84, Pls. Exhs. 5, 6, 13, 14, 21 and 22; Laun Tr. 80; O'Connor Tr. 3, 88-89; Stephens Tr. 7; Kendall Tr. 33). Mr. Haire, Anchor's Chairman, was in each instance a member of the Committee, which always operated by consensus (Haire Tr. 179, 298-99). All votes were unanimous, which, in effect, gave Anchor a veto as to who would be "independent" directors.

The next chart shows the composition of the Fund's board at the time each of the quorum directors were nominated for membership on the board.* Again, defendants' domination of the board is apparent.

* Mr. Laun was elected directly by the board.

Minority Directors	*Members of the Nominating Board of Directors*
1. Laun	Defendant Haire
	Defendant Burr
	Defendant Hutchison
	Defendant Phillips
	Defendant Kemmerer
	Defendant Burks
	Defendant Hopkins
	Defendant Monroney
	Defendant Wade
2. O'Connor	Defendant Haire
	Defendant Burr
	Defendant Hutchison
	Defendant Kemmerer
	Defendant Burks
	Defendant Hopkins
	Defendant Wade
	Mr. Martin—President of Anchor
	Mr. Laun
3. Stephens	Defendant Haire
	Defendant Burr
	Defendant Hutchison
	Defendant Phillips
	Defendant Kemmerer
	Defendant Hopkins
	Defendant Wade
	Mr. Martin—President of Anchor
	Mr. Laun
	Mrs. O'Connor
4. Robichaud	Defendant Haire
	Defendant Burr
	Defendant Hutchison

Minority Directors	*Members of the Nominating Board of Directors*
	Defendant Phillips
	Defendant Kemmerer
	Defendant Hopkins
	Defendant Wade
	Mr. Martin—President of Anchor
	Mr. Laun
	Mrs. O'Connor
	Mr. Taylor
5. Kendall	Defendant Haire*
	Defendant Burr*
	Defendant Hutchison*
	Defendant Kemmerer
	Defendant Phillips
	Mr. Martin—President of Anchor*
	Mr. Laun
	Mrs. O'Connor
	Mr. Stephens
	Ms. Robichaud

Doc. 76, Tersigni Affid., Sept. 20, 1976, Exhs. B, C, D, E, F.

In addition to defendants' control of the selection and nominating process, the quorum directors had a long history of social and business relationships with a number of defendants. Several lived in the same community and worked together with defendants in civic matters. Four of

* The four Anchor-affiliated directors abstained from voting on Mr. Kendall's nomination. Mr. Haire, however, had recommended Mr. Kendall in the first instance and had voted for him as a member of the Directors' Qualifications Committee (Haire Tr. 216; Kendall Tr. 32-33). Why these abstentions occurred remains an interesting question. They apparently were a belated effort to effectuate a semblance of independence.

the quorum directors testified that they considered one or more of the defendants to be a friend (Haire Tr. 145-47; Kendall Tr. 8, 12-14, 17-21, 71, 73; Laun Tr. 78-80; O'Connor Tr. 3-12; Stephens Tr. 7-8, 12-15). The minority directors and the defendants also worked and associated with each other at least once a month as members of the various Anchor Group's boards, for which they were paid $11,000 to $13,000 a year.

Based on the foregoing, the Court of Appeals determined that there was a symbiotic relationship between the Fund and Anchor and that irrespective of good faith, the minority directors could not have viewed the acts of their defendant colleagues with objectivity or impartiality (A. 46-47, 48 n.14). The facts set forth above fully support those findings and conclusively demonstrate a lack of independence and impartiality.

Numerous authorities establish that, under the circumstances of this case, the minority directors are not disinterested or independent. The process of selecting the minority directors followed the usual pattern of control in the mutual fund industry. "[O]bviously, you know and I know that if you are choosing an unaffiliated director or an independent director you are not going to choose anybody who is going to be too hard on you. You are going to tend to pick a friend of yours . . . ." *Conference on Mutual Funds*, 115 U. Pa. L. Rev. 662, 739 (1967) (remarks of Abraham L. Pomerantz, Esq.). "[T]hrough either informal suggestions or the veto often given the adviser's representatives on the committee [Mr. Haire], the selection of independent directors effectively remains in the adviser's hands." Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179, 216 (1971). *See also* Wharton School of Finance & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 465-66 (1962).

As Chairman Williams told the Investment Company Institute on May 17, 1978: "No matter how independent a director may be in fact, there will always be a question if he is selected by management." Williams, *A Challenge To Mutual Funds*, SEC News Release, May 17, 1978, p. 9.

In *Fogel* v. *Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the Second Circuit observed, "[u]nder the best of circumstances there is bound to be doubt about the independence of the 'unaffiliated' or now the 'disinterested' director . . . ."

In *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977), the SEC filed an *amicus* brief in which it stated: "Our experience is that rarely are the independent directors truly independent of domination by the adviser" (p. 37).*

Theodore A. Levine, the SEC's Assistant Director of the Division of Enforcement, has stated with respect to independent audit committees that "[t]he Commission might consider independence tainted if 'outside' officials are members of the same clubs, went to the same schools or lived in the same neighborhoods as 'inside directors.'" BNA, Sec. Reg. L. Rep., *News & Comment*, May 4, 1977, p. A-5. The same considerations clearly point to the fact that the minority here was not independent.

* How the SEC can conclude on the present record that the quorum directors were independent is a mystery and is belied by its more candid position in *Tannenbaum*. There is nothing in the record here to take this case out of the Commission's prior experience. How handpicked minority directors can possibly be independent nowhere is explained.

In an affidavit filed with the District Court, James C. Sargent, a former Commissioner of the SEC, expressed the view that a quorum of outside directors comprising a minority of a mutual fund's board of directors cannot be considered independent regarding a decision which would adversely affect the economic interests of majority directors (A. 153-54).*

These considerations are not unique to mutual funds. It has long been recognized that minority directors cannot be deemed independent with respect to charges of wrongdoing asserted against the majority.** Similarly, directors are not independent or disinterested where they are the nominees of a wrongdoer or where the wrongdoer dominates the management and operation of the corporation or controls the elective process.***

The minority directors in this case simply did not possess the requisite degree of independence necessary to permit them to attempt to exculpate the majority.

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* In a mutual fund control of the board obviously carries full control of the proxy machinery and the corporation. Wharton School of Finance & Commerce, *A Study of Mutual Funds*, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 64 (1962); Securities & Exchange Commission, *Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 129-30 (1966).

** *See* Point II, *supra*.

*** *See* Delaware & Hudson Co. v. Albany & Susquehanna R.R. Co., 213 U.S. 435, 443, 450-51 (1909); de Haas v. Empire Petroleum Co., 286 F.Supp. 809, 814 (D. Colo. 1968), *aff'd*, 435 F.2d 1223, 1228 (10th Cir. 1970); Kaminsky v. Abrams, 281 F.Supp. 501, 503 (S.D.N.Y. 1968); Heilbrunn v. Hanover Equities Corp., 259 F.Supp. 936, 939 (S.D.N.Y. 1966); Craftsman Fin. & Mortgage Co. v. Brown, 64 F.Supp. 168, 175 (S.D.N.Y. 1945); Ripley v. International Railways of Cent. America, 8 App. Div.2d 310, 317 (1st Dep't 1959), *aff'd*, 8 N.Y.2d 430 (1960).

B. *The Action Has Merit*

An examination of the facts at bar and the relevant authorities demonstrates that the Court of Appeals was undoubtedly correct in determining that this action has merit.

Judge Fuld repeatedly expressed his inability to find relevant authority on the issue of whether an investment adviser is required to make an independent investigation and analysis prior to causing an investment fund to purchase securities (A. 96, 97, 100, 102, 108). Unfortunately, he overlooked *Matter of Winfield & Co.*, [1971-72 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶78,530, p. 81,147 (SEC 1972), where the Securities and Exchange Commission expressly held that such a failure violated the antifraud provisions of the federal securities laws and Section 36 of the Investment Company Act. The Commission said

> The record shows that in many cases Meid relied on unsubstantiated representations of other persons, described by him as "research sources," and that such persons frequently had a substantial economic interest in the offering or the issuer of such securities. Adviser and Meid had an obligation to make a reasonable investigation before causing the Fund to purchase any securities.

Analogizing the adviser's duties to the duty of broker-dealers to make such investigations, the Commission stated

> The obligation of a broker-dealer in this area arises under the antifraud provisions of the federal securities laws. Those provisions are, of course, applicable as well to an investment adviser of a registered investment company. Moreover, when registered investment companies are involved, the obligation also is

imposed by Sections 15 and 36 of the Investment Company Act.

Id. at p. 81,147 n.14. *See also* Securities Act Release No. 4445, [1961-64 Transfer Binder] Fed.Sec.L.Rep. (CCH) ¶76,820, p. 81,068 (1962).

Judge Fuld, moreover, overlooked the line of cases in which the courts have held that broker-dealers have a duty to investigate and may not blindly accept the recommendations of others who are economically self-interested. *See, e.g., Hanly* v. *SEC,* 415 F.2d 589, 595-96 (2d Cir. 1969). Certainly, if broker-dealers have a duty to make an independent investigation, so must investment advisers, who receive millions of dollars in fees annually to make investment decisions for absent shareholders.

Judge Fuld also concluded that the principal adverse information concerning Penn Central was not available until April 23, 1970 and that Anchor probably could not have sold the paper at that time, even had it attempted to do so (A. 103). Yet, Mr. Haire disclosed at the December 18, 1974 meeting, after Judge Fuld had written his report, that Goldman, Sachs was repurchasing Penn Central paper up to May 1, 1970 (A. 121-22). Anchor made no effort to sell the paper until May 18, 1970, by which time it was too late (A. 87).*

* Reported decisions have found that adverse financial information concerning Penn Central was publicly available well before the time fixed by Judge Fuld. In Welch Foods Inc. v. Goldman, Sachs & Co., 398 F.Supp. 1393, 1398 (S.D.N.Y. 1974) the court said, "[e]nough objective data was known concerning Penn Central in early 1970 to lead a reasonable observer to conclude that the commercial paper was not prime, and indeed the issuer became insolvent very shortly thereafter." Other reported cases have depicted the continuing decline of Penn Central throughout 1969 and into early 1970 by virtue of its large financial losses "widely reported in the financial press." *See* University Hill Foundation v. Goldman, Sachs & Co., 422 F.Supp. 879, 889-90 (S.D.N.Y. 1976); Franklin Sav. Bank v. Levy, 551 F.2d 521, 523 (2d Cir. 1977). *See also* STAFF REPORT OF THE SECURITIES AND EXCHANGE COMMISSION, *The Financial Collapse of the Penn Central Company* 11-14, 279, 282 (August 1972).

Judge Fuld's conclusion that the Fund's directors were not liable was based in large measure on his conclusion that Anchor was not liable (A. 107-08). Yet it is quite clear that Anchor is liable. The Fund directors were grossly negligent in failing to oversee the Fund's investment policies and the procedures employed by Anchor.

Mr. Laun testified that Fund directors had an obligation to review Anchor's investment decisions (Laun Tr. 83). Mr. Kendall similarly testified that an investment adviser was obligated to perform research as part of its services and that the Fund directors "have a responsibility for the quality of the research . . ." (Kendall Tr. 44, 45-49, 212-13). These self-admitted obligations were ignored by the directors.

Judge Fuld's report further suggests that the directors are not liable because they were ignorant of the fact that Anchor had instituted a change in procedure and had begun purchasing dealer paper (A. 108). The report also establishes that Anchor was doing no independent investigation or review of the companies whose paper was being purchased and that short-term investments were lumped together and not separately identified in monthly reports reviewed by the directors (A. 108, 122-23). As a result, the directors didn't even know what purchases were being made and did nothing to inform themselves as to any of these matters. Such all-encompassing ignorance by the board presents a classic situation for the imposition of liability.

In *Stern* v. *Lucy Webb Hayes National Training School,* 381 F.Supp. 1003, 1013-14 (D.D.C. 1974) the court noted

A corporate director, on the other hand, may delegate his investment responsibility to fellow directors, corporate officers, or even outsiders, but he must continue to exercise general supervision over the activities of his delegates. . . .

Total abdication of the supervisory role, however, is improper even under traditional corporate principles. A director who fails to acquire the information necessary to supervise investment policy or consistently fails even to attend the meetings at which such policies are considered has violated his fiduciary duty to the corporation. 3 Fletcher Cyc. Corp. (Perm.Ed. Rev. 1965) § 1091 (1965). While a director is, of course, permitted to rely upon the expertise of those to whom he has delegated investment responsibility, such reliance is a tool for interpreting the delegate's reports, not an excuse for dispensing with or ignoring such reports. *See* Heit v. Bixby, 276 F.Supp. 217, 231 (E. D.Mo. 1967). A director whose failure to supervise permits negligent mismanagement by others to go unchecked has committed an independent wrong against the corporation . . . ."

See also Mann v. *Commonwealth Bond Corp.*, 27 F.Supp. 315 (S.D.N.Y. 1938).

It is well established that directors of financial institutions are held to a higher standard of care than directors of ordinary business corporations. *See Goodwin* v. *Simpson*, 292 Mass. 148, 150, 197 N.E. 628, 630 (1935); *O'Connor* v. *First National Investors' Corp.*, 163 Va. 908, 919-27, 177 S.E. 852, 857-60 (1935); *Hun* v. *Cary*, 82 N.Y. 65, 71 (1880).*

* *See also* Eisenberg & Lehr, *An Aspect of the Emerging "Federal Corporation Law": Directorial Responsibility Under the Investment Company Act of 1940*, 20 Rutgers L. Rev. 181, 188-89 (1966).

In *Brown* v. *Bullock*, 194 F.Supp. 207, 238 n.1 (S.D.N.Y.), *aff'd*, 294 F.2d 415 (2d Cir. 1961) the court said that Section 36 of the Investment Company Act imposes a fiduciary duty on investment company directors and advisers regarding the handling of other people's money. Here, the directors violated not only higher standards but the most basic obligation which they owed to the stockholders.

The Fund directors are also liable for negligence under Delaware law. In *Lutz* v. *Boas*, 39 Del. Ch. 585, 610, 171 A.2d 381, 396 (1961), the court stated

> I am satisfied that these directors are liable because I think it is clear that had they discharged their responsibilities as to general supervision they would have discovered these violations of Funds' investment policy. It is evident that the negligence of these directors can be considered a proximate cause of this loss to Funds.

See also Graham v. *Allis-Chalmers Manufacturing Co.*, 41 Del. Ch. 78, 84, 188 A.2d 125, 130 (1963); Fletcher, Cyclopedia Corporations §1019, p. 569 (Perm. ed. 1975).

The pending action is most certainly meritorious. Yet, Judge Fuld's contrary opinion was a key factor in leading the minority to seek dismissal of this action. As Mrs. O'Connor testified: "My basis for this decision was that Judge Fuld's opinion had brought out that Anchor and the director defendants were not guilty and that there was not merit in the case. And that was my decision" (O'Connor Tr. 74). *See also* Robichaud Tr. 118-19; Laun Tr. 33; A. 77-80, 131.

Thus, the fundamental factor on which the minority directors based their decision, that this action has no merit, was patently erroneous. As indicated by the Court of

Appeals, the pending action has substantial merit (A. 40-41, 43).

C. *The Minority Quorum Was Not Fully and Fairly Informed of All Relevant Facts*

Plaintiffs were not granted the opportunity to test whether the disclosures made to the minority directors and Judge Fuld were fair and adequate. Nevertheless, the limited record clearly reveals a total absence of candor. Obviously, this was to be expected in view of the fact that it was the defendants themselves who were "disclosing" the relevant facts.

1. Mr. Haire's Misrepresentations to the Minority Directors

The minority directors were misled into reaching the incredible belief that unless they attempted to terminate this action, they would have to terminate the Fund's advisory contract with Anchor (A. 77-78). For this reason they asked Mr. Souther, the Fund's litigation counsel, to prepare a memorandum outlining the procedures for changing advisers, which he did (A. 77, 135). The origin of their misinformation is directly traceable to Mr. Haire.

At the Fund's December 18, 1974 board meeting, Haire told the minority directors of the adverse impact on Anchor if this case were not terminated. In this connection he referred to the "substantial distraction to Anchor," the adverse effect on its ability "to attract and retain . . . highly qualified personnel" and its inability to satisfy a judgment in the full amount of the claims (A. 125-26).

There is no doubt that Haire's statements strongly influenced the minority directors. They concluded that an "adversary relationship" would develop between the Fund and Anchor if the case went forward and that the "serious distraction of Anchor's personnel . . . would leave us no

practical alternative but to remove Anchor as an investment adviser" (A. 77-78).

The record fails to disclose why this assertion was made to the minority directors in light of the fact that a number of prior derivative actions against Anchor had led to no such dislocation. *E.g., Gordon* v. *Fundamental Investors, Inc.*, 362 F.Supp. 41 (S.D.N.Y 1973); *Weiss* v. *Chalker*, 55 F.R.D. 168 (S.D.N.Y. 1972).

At his deposition, Haire substantially altered his views. He testified, "I have never at any time had any doubt that we could continue to effectively serve the fund . . . " (Haire Tr. 84, 283). He further testified that he never even considered the possibility of Anchor's advisory contract being terminated if the action went forward and that stockholder actions were simply a part of doing business in the mutual fund industry (Haire Tr. 85, 151).

The minority directors were not only misled, but their purported business reasons were disaffirmed by Mr. Haire, a principal defendant in the case.

Mr. Haire also told the minority directors at the December 18, 1974 board meeting that he believed Anchor's investment guidelines had been followed in connection with the Penn Central purchases (A. 121-22). The directors relied upon this information as a basis for their decision (A. 131).* Judge Fuld's report establishes without ques-

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* Mr. Laun testified

Q. Do you know whether Anchor made any investigation or analysis?

A. I know of no independent investigation or analysis that was made.

Q. Do you consider that relevant to whether or not they should be sued?

[Objection by counsel]

tion that two of the three guidelines were violated, including the failure to obtain a buy-back commitment from Goldman, Sachs (A. 84, 109, 113). Here again, the minority directors were affirmatively misled by Mr. Haire. It certainly cannot be said that they were fully and fairly informed.

As stated in *Papilsky* v. *Berndt*, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,627, p. 90,133 (S.D. N.Y. 1976), "the picture that emerges is one of Lord, Abbett [the adviser] funneling to the Board business reasons why one or another method of recapture would be a poor idea—business reasons that, we now are told, should not have precluded recapture . . . ." *See also Fogel* v. *Chestnutt*, 533 F.2d 731, 750 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976).

2. The Biased Participation of Mr. Souther

Full disclosure to the disinterested directors was further impaired because they were advised by the Fund's litigation counsel, Eugene P. Souther, an "interested person" under the Investment Company Act.*

At the quorum's December 18, 1974 meeting, Mr. Souther told the directors, in effect, why the Fund would have noth-

A. No. Because we were convinced that they had exercised what we felt was enough investigation into it.
Q. By relying on Goldman, Sachs?
A. And its willingness to repurchase.
Q. Did you believe—
A. And the Dun & Bradstreet rating.

Laun Tr. 75-76.

* Section 2(a)(19)(A)(iv), 15 U.S.C. §80a-2(a)(19)(A)(iv), defines "interested person" of an investment company as "any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company."

ing to gain if the action went forward. The minutes of the meeting, which he prepared, state

> The Chairman then called upon Mr. Souther, who discussed the practical implications of following each of the alternatives available to the Fund and the nature and extent of the proceedings each alternative would entail. Mr. Souther advised the Board that it could consider the possibility that as a result of retention by the Fund of a 73.75% interest in the notes under its settlement with Goldman, Sachs, the Fund might recover some additional amount in the reorganization of Penn Central. He also described the discovery proceedings and trial preparation that could be anticipated if the action were to continue and the type of work interruption that activity could entail, which might well have an adverse effect on the Fund's shareholders. Mr. Souther pointed out that there could be a substantial cost to the Fund for attorneys' fees for its counsel as well as for outside directors who were found not liable to the Fund. Finally, he told them that they could properly consider not only the chances of securing a substantial judgment against Anchor Corporation and possibly the director defendants, but also the practical possibility of collecting such a judgment.

A. 120.

Mr. Souther's description of the costs and inconveniences of litigation was biased. As long as the Fund, through its own counsel, was seeking recovery for its Penn Central losses against Goldman, Sachs, any cost or disruption to Anchor was justified. But as soon as plaintiffs, through their own counsel, sought to recover the far greater balance of the losses from Anchor and the defendant directors, the costs and inconveniences became excessive and unjustified.

At the quorum's January 6, 1975 meeting, Mr. Souther submitted a memorandum to the directors outlining the procedures for terminating Anchor's advisory contract and seeking a new adviser (A. 158). Rather than dispelling the directors' mistaken notion that they would have to terminate Anchor if this case went forward, Mr. Souther played out his part of the charade. Amidst a description of complexities, hardships and potentially harmful consequences of changing advisers, Mr. Souther's memorandum raised the spectre of a proxy contest, saying that "some shareholders" might oppose the selection of a new adviser and nominate their own slate of directors. The memorandum also indicated the prospect of a substantial number of shares being redeemed if there were a proxy contest and that such a contest might make it difficult for the Fund to obtain a new adviser (A. 159-60).

There is no question of the negative impact Mr. Souther's memorandum had on the minority directors. When asked of its effect, Ms. Robichaud testified

> Q. What consideration did you attach to this document?
>
> A. I attached to this document that it would fundamentally be in the bad interest of the stockholders to proceed with the suit. And that was the importance I attached to this document.
>
> Q. Can you explain why?
>
> A. Yes. As this document indicates, that if we were to proceed, let the suit proceed, there would be a question as to whether we would have to terminate the agreement with the investment advisor. And that, in seeing the sentence alone, would clearly not be in the interest of the stockholders.

Robichaud Tr. 107-08. Here, again, the minority directors were misled, rather than candidly informed. *See Papilsky* v. *Berndt,* [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶95,627, p. 90,133 (S.D.N.Y. 1976).

Even more amazing is Mr. Souther's lack of candor with respect to Judge Fuld. When Judge Fuld expressed inability to find specific authority dealing with the obligation of an investment adviser to conduct independent research, Mr. Souther apparently remained silent. He failed to disclose to Judge Fuld the legal authorities set forth above at pages 63-64. Particularly, he failed to disclose the crucial *Winfield* decision, even though he had been counsel in that litigation.

• • •

It is obvious that the minority directors were not the beneficiaries of adequate information. The entire scheme devised to achieve dismissal of this action was carefully orchestrated. As part of that scheme, the "independent" directors and their special counsel were spoon-fed bits and pieces of information—some of it misleading—and were not informed as to other important facts. The true facts pertinent to consideration of what action was required in the interest of the stockholders of the Fund, as distinguished from the adviser, were not before the minority.

D. *The Continued Prosecution of This Action Cannot Possibly Injure the Fund*

Mr. Kendall's affidavit purports to list reasons why dismissal of this action was appropriate (A. 77-79). We have already dealt with most of these items and it is clear that the assertions are without merit. Only two need further mention: that business interruption to Anchor and its personnel would be harmful to the Fund and that the Fund would have to replace Anchor as its adviser.

The recent withdrawal by Anchor completely destroys these alleged grounds and removes any remaining vestige of reason why this case should not go forward on the merits.

Finally, Mr. Kendall attempts to belittle the size of the claim here in relation to the total assets of the Fund. With interest, the claim exceeds $20,000,000—clearly not a paltry sum. As stated in *Groel* v. *United Electric Co. of New Jersey*, 70 N.J.Eq. 616, 624, 61 A. 1061, 1064 (1905)

> It is perfectly clear that, if the complainant sets forth a good cause of action and there is a right in the corporation to recover $20,000,000 of stock from the promoter, it is a clear breach of trust on the part of the directors not to proceed to recover the same.
>
> For them to reply that it is by them deemed inexpedient to do so is only to emphasize the breach of trust they are committing by not doing so.

CONCLUSION

The order of the Court of Appeals should be affirmed in all respects and the case remanded for trial on its merits.

Respectfully submitted,

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APPENDIX

Investment Company Act

§1. *Findings and declaration of policy*

(a) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z—4 of this title, and facts otherwise disclosed and ascertained, it is found that investment companies are affected with a national public interest in that, among other things—

(1) the securities issued by such companies, which constitute a substantial part of all securities publicly offered, are distributed, purchased, paid for, exchanged, transferred, redeemed, and repurchased by use of the mails and means and instrumentalities of interstate commerce, and in the case of the numerous companies which issue redeemable securities this process of distribution and redemption is continuous;

(2) the principal activities of such companies—investing, reinvesting, and trading in securities—are conducted by use of the mails and means and instrumentalities of interstate commerce, including the facilities of national securities exchanges, and constitute a substantial part of all transactions effected in the securities markets of the Nation;

(3) such companies customarily invest and trade in securities issued by, and may dominate and control or otherwise affect the policies and management of, companies engaged in business in interstate commerce;

(4) such companies are media for the investment in the national economy of a substantial part of the national savings and may have a vital effect upon the flow of such savings into the capital markets; and

(5) the activities of such companies, extending over many States, their use of the instrumentalities of interstate commerce and the wide geographic distribution of their security holders, make difficult, if not impossible, effective State regulation of such companies in the interest of investors.

(b) Upon the basis of facts disclosed by the record and reports of the Securities and Exchange Commission made pursuant to section 79z—4 of this title, and facts otherwise disclosed and ascertained, it is declared that the national public interest and the interest of investors are adversely affected—

(1) when investors purchase, pay for, exchange, receive dividends upon, vote, refrain from voting, sell, or surrender securities issued by investment companies without adequate, accurate, and explicit information, fairly presented, concerning the character of such securities and the circumstances, policies, and financial responsibility of such companies and their management;

(2) when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders;

(3) when investment companies issue securities containing inequitable or discriminatory provisions, or

fail to protect the preferences and privileges of the holders of their outstanding securities;

(4) when the control of investment companies is unduly concentrated through pyramiding or inequitable methods of control, or is inequitably distributed, or when investment companies are managed by irresponsible persons;

(5) when investment companies, in keeping their accounts, in maintaining reserves, and in computing their earnings and the asset value of their outstanding securities, employ unsound or misleading methods, or are not subjected to adequate independent scrutiny;

(6) when investment companies are reorganized, become inactive, or change the character of their business, or when the control or management thereof is transferred, without the consent of their security holders;

(7) when investment companies by excessive borrowing and the issuance of excessive amounts of senior securities increase unduly the speculative character of their junior securities; or

(8) when investment companies operate without adequate assets or reserves.

It is declared that the policy and purposes of this subchapter, in accordance with which the provisions of this subchapter shall be interpreted, are to mitigate and, so far as is feasible, to eliminate the conditions enumerated in this section which adversely affect the national public interest and the interest of investors.

• • •

§2. ***Definitions***

(a) When used in this subchapter, unless the context otherwise requires—

. . .

(19) "Interested person" of another person means—

(A) when used with respect to an investment company—

(i) any affiliated person of such company,

(ii) any member of the immediate family of any natural person who is an affiliated person of such company,

(iii) any interested person of any investment adviser of or principal underwriter for such company,

(iv) any person or partner or employee of any person who at any time since the beginning of the last two fiscal years of such company has acted as legal counsel for such company,

(v) any broker or dealer registered under the Securities Exchange Act of 1934 or any affiliated person of such a broker or dealer, and

(vi) any natural person whom the Commission by order shall have determined to be an interested person by reason of having had, at any time since the beginning of the last two fiscal years of such company, a material business or professional relationship with such company or with the principal executive officer of such company or with any other investment company having the same investment adviser or principal underwriter or with the principal executive officer of such other investment company:

Provided, That no person shall be deemed to be an interested person of an investment company solely by reason of (aa) his being a member of its board of directors or advisory board or an owner of its securities, or (bb) his membership in the immediate family of any person specified in clause (aa) of this proviso.

• • •

§10. ***Affiliations or interest of directors, officers, and employees***

(a) No registered investment company shall have a board of directors more than 60 per centum of the members of which are persons who are interested persons of such registered company.

(b) No registered investment company shall—

(1) employ as regular broker any director, officer, or employee of such registered company, or any person of which any such director, officer, or employee is an affiliated person, unless a majority of the board of directors of such registered company shall be persons who are not such brokers or affiliated persons of any of such brokers;

(2) use as a principal underwriter of securities issued by it any director, officer, or employee of such registered company or any person of which any such director, officer, or employee is an interested person, unless a majority of the board of directors of such registered company shall be persons who are not such

principal underwriters or interested persons of any of such principal underwriters; or

(3) have as director, officer, or employee any investment banker, or any affiliated person of an investment banker, unless a majority of the board of directors of such registered company shall be persons who are not investment bankers or affiliated persons of any investment banker. For the purposes of this paragraph, a person shall not be deemed an affiliated person of an investment banker solely by reason of the fact that he is an affiliated person of a company of the character described in section 80a—12(d)(3)(A)(B) of this title.

• • •

§13. *Changes in investment policy*

(a) No registered investment company shall, unless authorized by the vote of a majority of its outstanding voting securities—

. . .

(3) deviate from its policy in respect of concentration of investments in any particular industry or group of industries as recited in its registration statement, deviate from any investment policy which is changeable only if authorized by shareholder vote, or deviate from any policy recited in its registration statement pursuant to section 80a—8(b)(3) of this title:

• • •

§15. *Contracts of advisers and underwriters*

. . .

(c) In addition to the requirements of subsections (a) and (b) of this section, it shall be unlawful for any reg-

istered investment company having a board of directors to enter into, renew, or perform any contract or agreement, written or oral, whereby a person undertakes regularly to serve or act as investment adviser of or principal underwriter for such company, unless the terms of such contract or agreement and any renewal thereof have been approved by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party, cast in person at a meeting called for the purpose of voting on such approval. It shall be the duty of the directors of a registered investment company to request and evaluate, and the duty of an investment adviser to such company to furnish, such information as may reasonably be necessary to evaluate the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company. It shall be unlawful for the directors of a registered investment company, in connection with their evaluation of the terms of any contract whereby a person undertakes regularly to serve or act as investment adviser of such company, to take into account the purchase price or other consideration any person may have paid in connection with a transaction of the type referred to in paragraph (1), (3), or (4) of subsection (f) of this section.

• • •

§16. *Board of directors; election; term vacancies; trustees of common-law trusts*

. . .

(b) Any vacancy on the board of directors of a registered investment company which occurs in connection with compliance with section 80a—15(f)(1)(A) of this title and which must be filled by a person who is not an interested

person of either party to a transaction subject to section 80a—15(f)(1)(A) of this title shall be filled only by a person (1) who has been selected and proposed for election by a majority of the directors of such company who are not such interested persons, and (2) who has been elected by the holders of the outstanding voting securities of such company, except that in the case of the death, disqualification, or bona fide resignation of a director selected and elected pursuant to clauses (1) and (2) of this subsection (b), the vacancy created thereby may be filled as provided in subsection (a) of this section.

* * *

§17. *Transactions of certain affiliated persons and underwriters*

(a) It shall be unlawful for any affiliated person or promoter of or principal underwriter for a registered investment company (other than a company of the character described in section 80a—12(d) (3) (A) and (B) of this title), or any affiliated person of such a person, promoter, or principal underwriter, acting as principal—

(1) knowingly to sell any security or other property to such registered company or to any company controlled by such registered company, unless such sale involves solely (A) securities of which the buyer is the issuer, (B) securities of which the seller is the issuer and which are part of a general offering to the holders of a class of its securities, or (C) securities deposited with the trustee of a unit investment trust or periodic payment plan by the depositor thereof;

(2) knowingly to purchase from such registered company, or from any company controlled by such

registered company, any security or other property (except securities of which the seller is the issuer); or

(3) to borrow money or other property from such registered company or from any company controlled by such registered company (unless the borrower is controlled by the lender) except as permitted in section 80a—21(b) of this title.

(b) Notwithstanding subsection (a) of this section, any person may file with the Commission an application for an order exempting a proposed transaction of the applicant from one or more provisions of said subsection. The Commission shall grant such application and issue such order of exemption if evidence establishes that—

(1) the terms of the proposed transaction, including the consideration to be paid or received, are reasonable and fair and do not involve overreaching on the part of any person concerned;

(2) the proposed transaction is consistent with the policy of each registered investment company concerned, as recited in its registration statement and reports filed under this subchapter; and

(3) the proposed transaction is consistent with the general purposes of this subchapter.

(c) Notwithstanding subsection (a) of this section, a person may, in the ordinary course of business, sell to or purchase from any company merchandise or may enter into a lessor-lessee relationship with any person and furnish the services incident thereto.

(d) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company

(other than a company of the character described in section 80a—12(d) (3) (A) and (B) of this title), or any affiliated person of such a person or principal underwriter, acting as principal to effect any transaction in which such registered company, or a company controlled by such registered company, is a joint or a joint and several participant with such person, principal underwriter, or affiliated person, in contravention of such rules and regulations as the Commission may prescribe for the purpose of limiting or preventing participation by such registered or controlled company on a basis different from or less advantageous than that of such other participant. Nothing contained in this subsection shall be deemed to preclude any affiliated person from acting as manager of any underwriting syndicate or other group in which such registered or controlled company is a participant and receiving compensation therefor.

(e) It shall be unlawful for any affiliated person of a registered investment company, or any affiliated person of such person—

(1) acting as agent, to accept from any source any compensation (other than a regular salary or wages from such registered company) for the purchase or sale of any property to or for such registered company or any controlled company thereof, except in the course of such person's business as an underwriter or broker; or

(2) acting as broker, in connection with the sale of securities to or by such registered company or any controlled company thereof, to receive from any source a commission, fee, or other remuneration for effecting such transaction which exceeds (A) the usual and customary broker's commission if the sale is effected on a securities exchange, or (B) 2 per centum of the sales price if the sale is effected in connection with a secondary distribution of such securities, or (C) 1 per centum of the purchase or sale price of such securities if the sale is otherwise effected unless the Commission shall, by rules and regulations or order in the public interest and consistent with the protection of investors, permit a larger commission.

(f) Every registered management company shall place and maintain its securities and similar investments in the custody of (1) a bank or banks having the qualifications prescribed in paragraph (1) of section 80a—26(a) of this title for the trustees of unit investment trusts; or (2) a company which is a member of a national securities exchange as defined in the Securities Exchange Act of 1934, subject to such rules and regulations as the Commission may from time to time prescribe for the protection of investors; or (3) such registered company, but only in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors. Subject to such rules, regulations, and orders as the Commission may adopt as necessary or appropriate for the protection of investors, a registered management company or any such custodian, with the consent of the registered management company for which it acts as custodian, may deposit all or any part of the securities owned by such registered management company in a system for the central handling of securities established by a national securities exchange or national securities association registered with the Commission under the Securities Exchange Act of 1934, or such other person as may be per-

mitted by the Commission, pursuant to which system all securities of any particular class or series of any issuer deposited within the system are treated as fungible and may be transferred or pledged by bookkeeping entry without physical delivery of such securities. Rules, regulations, and orders of the Commission under this subsection, among other things, may make appropriate provision with respect to such matters as the earmarking, segregation, and hypothecation of such securities and investments, and may provide for or require periodic or other inspections by any or all of the following: Independent public accountants, employees and agents of the Commission, and such other persons as the Commission may designate. No such member which trades in securities for its own account may act as custodian except in accordance with rules and regulations prescribed by the Commission for the protection of investors. If a registered company maintains its securities and similar investments in the custody of a qualified bank or banks, the cash proceeds from the sale of such securities and similar investments and other cash assets of the company shall likewise be kept in the custody of such a bank or banks, or in accordance with such rules and regulations or orders as the Commission may from time to time prescribe for the protection of investors, except that such a registered company may maintain a checking account in a bank or banks having the qualifications prescribed in paragraph (1) of section 80a—26(a) of this title for the trustees of unit investment trusts with the balance of such account or the aggregate balances of such accounts at no time in excess of the amount of the fidelity bond, maintained pursuant to subsection (g) of this section, covering the officers or employees authorized to draw on such account or accounts.

(g) The Commission is authorized to require by rules and regulations or orders for the protection of investors that any officer or employee of a registered management investment company who may singly, or jointly with others, have access to securities or funds of any registered company, either directly or through authority to draw upon such funds or to direct generally the disposition of such securities (unless the officer or employee has such access solely through his position as an officer or employee of a bank) be bonded by a reputable fidelity insurance company against larceny and embezzlement in such reasonable minimum amounts as the Commission may prescribe.

(h) After one year from the effective date of this subchapter, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office.

In the event that any such instrument does not at the effective date of this chapter comply with the requirements of this subsection and is not amended to comply therewith prior to the expiration of said one year, such company may nevertheless continue to be a registered investment company and shall not be deemed to violate this subsection if prior to said expiration date each such director or officer shall have filed with the Commission a waiver in writing of any protective provision of the in-

strument to the extent that it does not comply with this subsection, and each such person subsequently elected or appointed shall before assuming office file a similar waiver.

(i) After one year from the effective date of this subchapter no contract or agreement under which any person undertakes to act as investment adviser of, or principal underwriter for, a registered investment company shall contain any provision which protects or purports to protect such person against any liability to such company or its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, or gross negligence, in the performance of his duties, or by reason of his reckless disregard of his obligations and duties under such contract or agreement.

In the event that any such contract or agreement does not at the effective date of this chapter comply with the requirements of this subsection and is not amended to comply therewith prior to the expiration of said one year, this subsection shall not be deemed to have been violated if prior to said expiration date each such investment adviser or principal underwriter shall have filed with the Commission a waiver in writing of any protective provision of the contract or agreement to the extent that it does not comply with this subsection.

(j) It shall be unlawful for any affiliated person of or principal underwriter for a registered investment company or any affiliated person of an investment adviser of or principal underwriter for a registered investment company, to engage in any act, practice, or course of business in connection with the purchase or sale, directly or indirectly, by such person of any security held or to be acquired by such registered investment company in contravention of such

rules and regulations as the Commission may adopt to define, and prescribe means reasonably necessary to prevent, such acts, practices, or courses of business as are fraudulent, deceptive or manipulative. Such rules and regulations may include requirements for the adoption of codes of ethics by registered investment companies and investment advisers of, and principal underwriters for, such investment companies establishing such standards as are reasonably necessary to prevent such acts, practices, or courses of business.

* * *

§32. *Accountants and auditors*

(a) It shall be unlawful for any registered management company or registered face-amount certificate company to file with the Commission any financial statement signed or certified by an independent public accountant, unless—

(1) such accountant shall have been selected at a meeting held within thirty days before or after the beginning of the fiscal year or before the annual meeting of stockholders in that year by the vote, cast in person, of a majority of those members of the board of directors who are not interested persons of such registered company;

(2) such selection shall have been submitted for ratification or rejection at the next succeeding annual meeting of stockholders if such meeting be held, except that any vacancy occurring between annual meetings, due to the death or resignation of the accountant, may be filled by the vote of a majority of those members of the board of directors who are not interested persons

of such registered company, cast in person at a meeting called for the purpose of voting on such action;

(3) the employment of such accountant shall have been conditioned upon the right of the company by vote of a majority of the outstanding voting securities at any meeting called for the purpose to terminate such employment forthwith without any penalty; and

(4) such certificate or report of such accountant shall be addressed both to the board of directors of such registered company and to the security holders thereof.

If the selection of an accountant has been rejected pursuant to paragraph (2) or his employment terminated pursuant to paragraph (3), the vacancy so occurring may be filled by a vote of a majority of the outstanding voting securities, either at the meeting at which the rejection or termination occurred or, if not so filled, at a subsequent meeting which shall be called for the purpose. In the case of a common-law trust of the character described in section 80a—16(c) of this title, no ratification of the employment of such accountant shall be required but such employment may be terminated and such accountant removed by action of the holders of record of a majority of the outstanding shares of beneficial interest in such trust in the same manner as is provided in section 80a—16(c) of this title in respect of the removal of a trustee, and all the provisions therein contained as to the calling of a meeting shall be applicable. In the event of such termination and removal, the vacancy so occurring may be filled by action of the holders of record of a majority of the shares of beneficial interest either at the meeting, if any, at which such termination and removal occurs, or by instruments in writing filed with the custodian,

or if not so filed within a reasonable time then at a subsequent meeting which shall be called by the trustees for the purpose. The provisions of paragraph (42) of section 80a—2(a) of this title as to a majority shall be applicable to the vote cast at any meeting of the shareholders of such a trust held pursuant to this subsection.

• • •

§36. [Effective prior to December 14, 1970]
Injunctions against Gross Abuse

The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has been guilty, after August 22, 1940, and within five years of the commencement of the action of gross misconduct or gross abuse of trust in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If the Commission's allegations of such gross misconduct or gross abuse of trust are established, the court shall enjoin such person from acting in such capacity or capacities either permanently or for such period of time as it in its discretion shall deem appropriate.

• • •

§36. [Effective December 14, 1970]

Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of any advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 80a—1(b) of this title.

Compensation or payments as basis of fiduciary duty; civil actions by Commission or security holder; burden of proof; judicial consideration of director or shareholder approval; persons liable; extent of liability; exempted transactions; jurisdiction; finding restriction

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of con-

tracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 80a—17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this subchapter for the purposes of sections 80a—9 and 80a—48 of this title, section 78 of this title, or section 80b—3 of this title, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section.

Investment Advisers Act

§206. ***Prohibited transactions by investment advisers***

It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud any client or prospective client;

(2) to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

(3) acting as principal for his own account, knowingly to sell any security to or purchase any security from a client, or acting as broker for a person other than such client, knowingly to effect any sale or purchase of any security for the account of such client, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction. The prohibitions of this paragraph shall not apply to any transaction with a customer of a broker or dealer if such broker or dealer is not acting as an investment adviser in relation to such transaction;

(4) to engage in any act, practice, or course of business which is fraudulent, deceptive, or manipulative. The Commission shall, for the purposes of this paragraph (4) by rules and regulations define, and prescribe means reasonably designed to prevent, such acts, practices, and courses of business as are fraudulent, deceptive, or manipulative.

Federal Rules of Civil Procedure

Rule 23.1. *Derivative Actions by Shareholders*

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

No. 77-1724

IN THE

Supreme Court of the United States

October Term, 1978

HARRY G. BURKS, Jr., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

PETITIONERS' REPLY BRIEF

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January 8, 1979

INDEX

Citations

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PETITIONERS' REPLY BRIEF

In this Reply Brief we deal with the following matters: A. the essential differences between the parties; B. the "mootness" argument; C. the specific points raised by plaintiffs.

A.

The essential differences between the parties

Respondents' Brief contains two principal contentions: (1) that disinterested directors of a mutual fund constituting less than a numerical majority of the Board, even though they be a valid quorum, can *never* terminate derivative litigation commenced by a stockholder (Respondents' Brief, Points I-III), and (2) that these particular disinterested directors, on the facts of this case, should not be permitted to terminate this particular stockholders' derivative litigation (Respondents' Brief, Point V).

The position taken by plaintiffs in Points I-III, which was substantially adopted by the Court of Appeals, is defective in its absolutism—it is an extreme position, at variance with basic principles of corporate governance, and one which could force large public mutual funds to maintain

unwarranted litigation at the command of one unrealistic or ill-motivated stockholder. Under plaintiffs' view of the matter, one stockholder can arrogate the power of the Board to himself merely by filing a derivative action naming all or a majority of the directors of the fund as defendants. Such a result would gravely undermine the role of directors, particularly disinterested directors, and would destroy an "important shareholder protection device" (See SEC Brief, p. 22).

Plaintiffs erroneously contend that defendants seek the absolute power to terminate stockholder derivative litigation. To the contrary, defendants do and always have maintained that the disinterested directors have the power *provided* they make a good faith exercise of business judgment. Implicit in that basic concept are a number of elements, all of which have been discussed in our original brief. Accordingly, plaintiffs have the matter backwards when they contend, as they do, that defendants seek an absolute out—it is plaintiffs who, under any and all circumstances, refuse to credit the disinterested directors' exercise of business judgment.

The position taken by plaintiffs in Point V, where they indiscriminately vilify the individuals in this case,* is unfounded and contrary to the record evidence. Plaintiffs' unsupported charges are in conflict with the findings of the District Court, the observations of the Court of Appeals and the position of the SEC, as will be documented below in our specific reply to Point V. Plaintiffs, alone, the "self-chosen representatives and volunteer champions" in the words of Mr. Justice Jackson,* perceive evil in this intra-corporate resolution of a corporate matter. Their charges of impropriety are unfounded and becloud the important and fundamental issue before this Court.

* Plaintiffs attack not only the individuals in this case, but the entire mutual fund industry. Their criticism of the industry is based on outdated source material and the self-interested views of members of the class action bar (e.g., Messrs. Pomerantz, Bernstein, etc.). The most recent Congressional findings in this area, by the Senate Committee on Banking and Currency, at the time of the important 1970 amendments, contained the following statement (S. Rep. No. 91-184, 91st Cong., 1st Sess. at 4 (1969), reprinted in 3 U.S. Code Cong. & Ad. News 4897 at 4900 (1970)):

> "Your committee agrees 'that on the whole the investment company industry reflects diligent management by competent persons.' [footnote omitted] The high standards of conduct of the industry since 1940 in the areas specifically covered in the statute are in sharp contrast to the derelictions in the handling of other people's money regrettably present in the investment company industry in the 1920's and 1930's."

B.

The "mootness" argument

Plaintiffs suggest that the writ of *certiorari* granted in this case should be dismissed as "moot" (Respondents' Brief, p. 13). The asserted basis of this suggestion is that in 1978—more than three years after the disinterested directors exercised their business judgment to terminate this action—Anchor ceased to be the investment adviser to Fundamental and, therefore, it is no longer true that allowing this action to go forward would place Fundamental in an adversary relationship with its investment adviser.

This argument is wholly without force for several reasons: (1) the issue tendered to this Court as the basis for granting *certiorari* was whether the disinterested directors had the *power* to exercise their business judgment to terminate this derivative action—not whether one or more of the reasons relied on by the directors for doing so was good and sufficient; (2) the possibility of creating an adversary relationship was only one of many factors relied on by the disinterested directors in reaching their decision to seek termination of this action (see Petitioners' Brief,

* *Cohen* v. *Beneficial Industrial Loan Corp.*, 337 U.S. 541, 549 (1949).

pp. 11-13), and (3) the decision of the disinterested directors should be judged in light of the circumstances at the time of their decision—no one foresaw in January 1975 that Anchor would retire from the investment advisory business in July 1978.

The proposed sale of Anchor's investment advisory business was publicly announced in February 1978; proxy statements seeking approval of a contract with the successor investment adviser were mailed to all shareholders of the funds—including plaintiffs—in June 1978; plaintiffs did not file their brief in opposition to *certiorari* until July 1978, and *certiorari* was not granted until October 1978. Plaintiffs could easily have raised this point *prior* to the granting of *certiorari*, but evidently chose not to do so until three weeks before the case was set for oral argument in this Court. Plaintiffs should not be permitted to derail consideration of this important case at the 11th hour on the basis of an alleged "change in circumstances"* which was known to them long before *certiorari* was granted and which, in any event, does not moot the fundamental issue presented by this case.

C.
Reply to Plaintiffs' Specific Points
Reply to Point I

Plaintiffs argue, in Point I A, that the "policy" of the Investment Company Act of 1940 demonstrates that the

* *Bankers Trust Co.* v. *Mallis*, 435 U.S. 381, *reh. denied*, 436 U.S. 915 (1978), the case cited by plaintiffs in support of their "change in circumstances" argument, is inapposite. In that case, respondent, who had won in the Court of Appeals, conceded on oral argument in this Court that the Court of Appeals had erred, but argued that the decision of the Court of Appeals should be affirmed on another ground. No such concession of error by the Court of Appeals has been made by respondents in this case, nor have they changed their theory of the case, which was adopted by the Court of Appeals, i.e. that the disinterested directors lack the power to terminate this stockholders' derivative action. Furthermore, petitioners' theory and the basic issue presented have remained constant throughout the entire course of proceedings.

disinterested directors lack the power to seek to terminate stockholder derivative litigation (Respondents' Brief, pp. 16-20). In support of their argument, plaintiffs rely on Sections 1 and 17 of the Investment Company Act of 1940 —their reliance is misplaced.

Neither Section 1 nor Section 17 deals directly or indirectly with the power of disinterested directors to terminate stockholder derivative litigation which they determine to be contrary to the best interests of the fund and its shareholders.

Section 1 is merely a generalized policy statement, enunciated 38 years ago at the time of the passage of the original statute—it has no applicability whatsoever to the issue raised in this case. Section 1(b) (2), the particular subsection upon which plaintiffs rely, declares that the national public interest and the interest of investors are adversely affected

> "when investment companies are organized, operated, managed, or their portfolio securities are selected, in the interest of directors, officers, investment advisers, depositors, or other affiliated persons thereof, in the interest of underwriters, brokers, or dealers, in the interest of special classes of their security holders, or in the interest of other investment companies or persons engaged in other lines of business, rather than in the interest of all classes of such companies' security holders. . . ."

Obviously, that section is not directed at situations such as the one at bar—it is addressed to self-dealing and other such abuses by insiders. Here the decision to forego litigation was made by a quorum of *outside* directors who were found by the District Court to have been "truly disinterested and independent" and by the Court of Appeals to have acted "in good faith in all that they did."

Similarly, Section 17, by its own terms, has no applicability to the issue raised in this case—that section deals, among other things, with sales to and purchases of securities from funds by insiders, borrowing of money by insiders, etc., i.e. matters not even remotely involved in this case. Section 17(h), the particular subsection on which plaintiffs rely, provides in pertinent part:

> "After one year from the effective date of this title, neither the charter, certificate of incorporation, articles of association, indenture of trust, nor the by-laws of any registered investment company, nor any other instrument pursuant to which such a company is organized or administered, shall contain any provision which protects or purports to protect any director or officer of such company against any liability to the company or to its security holders to which he would otherwise be subject by reason of willful misfeasance, bad faith, gross negligence or reckless disregard of the duties involved in the conduct of his office."

Plaintiffs argued below that the quorum provisions in Fundamental's by-laws violate Section 17(h) (See Appellants' Brief to the Court of Appeals, pp. 12-16). Evidently they have abandoned that extreme position and now argue merely that the quorum provisions violate the "policy" embodied in Section 17(h) (Respondents' Brief, p. 19). This borders on the absurd. Fundamental's quorum provisions are the normal, straightforward provisions found in the by-laws and/or charters of virtually every corporation of any kind, and they do not exculpate anyone from any liability. The motion by the disinterested directors to dismiss was not premised, as plaintiffs mistakenly argue, on the quorum provisions, but rather on the business judgment power and responsibility of the

directors to manage the affairs of the fund in the best interests of all shareholders.

Chabot v. *Empire Trust Co.*, 301 F.2d 458 (2d Cir. 1962) cited by plaintiffs (Respondents' Brief, pp. 19-20) is not in point. In that case, there was an express provision in a trust agreement requiring shareholders to post a bond to indemnify the trustee for costs and expenses in actions brought by shareholders against the trustee. The plaintiffs there had to post $35,000 as security in order to maintain their action. The Court held that this clause had the practical effect of shielding the trustee from liability by preventing lawsuits. The quorum provisions of Fundamental's by-laws and charter do not shield anybody from anything—they simply set forth how many directors are necessary to transact the business of the fund and, in this respect, are entirely standard.

Levitt v. *Johnson*, 334 F.2d 815 (1st Cir. 1964), *cert. denied*, 379 U.S. 961 (1965) also cited by plaintiffs (Respondents' Brief, p. 20), has nothing to do with Section 17 and has no bearing on this case. In that case, which involved the special Massachusetts shareholder demand rule, the question before the Court was whether a demand upon *shareholders* is necessary prior to the commencement of a derivative action under the Investment Company Act of 1940. *Levitt* did not deal with the question of whether *directors* can, in any event, exercise their business judgment to terminate a derivative action.

Plaintiffs next argue, in Point I B, that the powers conferred on the directors under the Investment Company Act of 1940 do not include the power to terminate stockholder derivative litigation (Respondents' Brief, pp. 20-30)—this misses the point.

As the SEC has said in its *amicus* brief filed in this case (SEC Brief, pp. 20-21):

> "The court of appeals appears to have relied on the fact that the Act does not specifically grant the disinterested directors authority to terminate ongoing derivative litigation. But the Act does not purport to withdraw such powers either, and it does not set out every duty and power of such directors. When Congress intended to eliminate the authority of the company's directors under the Act, it did so expressly.
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> * * *
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> Although Congress could have prohibited the disinterested directors from exercising business judgment in the circumstances of this case, it did not do so."

In support of their argument in Point I B, plaintiffs grossly misstate the findings of the Senate Report (Respondents' Brief, p. 24). Thus, plaintiffs state that the Senate Report "found that disinterested directors of mutual funds had no real independence from the adviser . . ." and that "Congress concluded that the disinterested directors were not sufficiently independent to protect shareholder interests in this regard." In support of their claim, plaintiffs cite page 4901 of the reprint of the Senate Report. Examination of that page reveals no such finding or conclusion by the Committee. Furthermore, plaintiffs' statements distort the entire thrust of the 1970 amendments. The concept of "disinterested" directors, with considerably stiffer requirements for qualification, was introduced in new Section 2(a)(19) to remedy criticisms of the prior category of "unaffiliated" directors. S. Rep. No. 91-184, 91st Cong., 1st Sess. at 32-33 (1969), reprinted in 3 U.S. Code

Cong. & Ad. News 4897 at 4927-28 (1970). Contrary to plaintiffs' misleading statements, Congress most assuredly did conclude that disinterested directors were sufficiently independent to protect shareholder interests. Again, as the SEC has said in its *amicus* brief in this case (SEC Brief, p. 22):

> ". . . The premise of the court of appeals—that disinterested directors are incapable of acting independently for the benefit of shareholders—conflicts with the congressional determination in 1970 that such directors are 'to supply an independent check on management and to provide a means for the representation of shareholder interests.' H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970)." *

Finally, the remarks of Chairman Williams of the SEC on the *Lasker* case, quoted in Respondents' Brief, pp. 28-29 n.*, were made without benefit of a reading of the record. In any event, the official position of the SEC is set forth in its *amicus* brief, from which there is no indication of a dissent by Chairman Williams.

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* See also S. Rep. No. 91-184, 91st Cong., 1st Sess. at 32-33 1969), reprinted in 3 U.S. Code Cong. & Ad. News 4897 at 4927-28 (1970):

> "The function of these provisions [prior Sections 2(a)(3) and 10] with respect to unaffiliated directors is to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.
>
> "Your committee believes that the definition of 'affiliated person' in section 2(a)(3) of the act does not adequately meet this purpose. . . .
>
> * * *
>
> "Proposed section 2(3) of this bill seeks to remedy the act's deficiencies in this regard by adding a new section 2(a)(19) to the act which would define the term 'interested person'. Other sections of the bill would substitute that term for the present term 'affiliated person' in . . . sections [10, 15 and 32(a)] of the act. . . ."

Reply to Point II

Plaintiffs argue, in Point II, that a "minority of directors" has no power to prevent or halt derivative litigation (Respondents' Brief, pp. 30-31)—this is erroneous.

The pertinent inquiry is whether or not there is a duly constituted quorum—not whether the quorum is a majority or minority of the directors. In this case 5 of 11 directors (constituting more than a quorum) acted with the full power of the Board—would plaintiffs have viewed the matter any differently if 6 of 11 had acted?— would 6 of 11 have been any more independent than 5 of 11? The numbers test that plaintiffs seek to impose is wholly artificial and has no support in applicable corporate law.

Delaware Corporation Law and Fundamental's by-laws both provide that a quorum may act with the full power of the Board. Indeed, a majority of a quorum may act with the full power of the Board—this is a fundamental principle of law which plaintiffs seek to overturn.

As the Court stated in *Benintendi* v. *Kenton Hotel*, 294 N.Y. 112, 119, 60 N.E.2d 829, 831-32 (1945):

> "the very idea of a 'quorum' is that, when that required number of persons goes into session as a body, the votes of a majority thereof are sufficient for binding action."

See also *Crowley* v. *Commodity Exchange*, 141 F.2d 182, 188-89 (2d Cir. 1944).

A quorum is empowered to act whether it is a majority or a minority of the Board. See, e.g.: *Potter* v. *Patee*, 493 S.W.2d 58, 64 (Mo. Ct. App. 1973), *motion denied; Twisp Min. & Smelt. Co.* v. *Chelan Min. Co.*, 16 Wash.2d 264, 290, 133 P.2d 300, 310-11 (1943); *Stott.* v *Stott Realty Co.*, 246 Mich, 267, 271-72, 224 N.W. 623, 624 (1929).

As the Court stated in *Twisp, supra* (16 Wash.2d at 290, 133 P.2d at 311), referring to 2 Fletcher, *Cyclopedia of Corporations* § 421:

> "A careful study of Fletcher will, in our opinion, reveal that the text recognizes that the number of directors of a corporation necessary to constitute a quorum may be fixed by the by-laws, if not incompatible with the articles or statutory law, and that a majority of that quorum may decide any question coming properly before such meeting, although the number of directors present may be less than a majority of the entire board."

Plaintiffs also argue, in Point II, that if a minority of directors could terminate stockholder derivative litigation it "would unsettle the whole doctrine of shareholder demand and excuse therefrom"—this, too, is erroneous.

First, it is simply incorrect to contend that the concept of a "majority" is an inherent or essential part of the demand rule. Rule 23.1 does not mention either a majority or a minority. There is nothing in the demand rule that bars a lawful minority quorum from passing on a demand by a putative derivative suit plaintiff. If and when a demand is made on the directors, nothing requires all the directors, or even a majority of them, to function on the demand. As with any other corporate business, in the absence of an express by-law or charter provision to the contrary, any duly constituted quorum of the Board can function in response to the demand; and, when it does, the vote of a majority of the quorum would be sufficient.

Second, demand is properly excused only when it would be "futile", not whenever a majority of the Board

is named as defendants.* In some cases, demand is futile where a majority of the Board is named as defendants, but that is not always the case. If it were, derivative plaintiffs could consign the demand rule to oblivion with the stroke of a pen by simply naming all directors defendants, irrespective of their true role in the matter. The test is: can a plaintiff allege facts that show that demand would be futile? See, e.g., *Heit* v. *Baird*, 567 F.2d 1157, 1162 (1st Cir. 1977); *In re Kauffman Mutual Fund Actions*, 479 F. 2d 257, 265 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); *Brooks* v. *American Export Industries*, 68 F.R.D. 506, 511 (S.D.N.Y. 1975); *Phillips* v. *Bradford*, 62 F.R.D. 681, 688 (S.D.N.Y. 1974).

The Court of Appeals held in *Heit, supra* (567 F.2d at 1162):

> "The plaintiff attempts to make up for the complaint's deficiencies in respect to Rule 23.1 by pointing out that more than a majority of the present board of directors are defendants in this suit and thereby in a position where they would not assent to its prosecution. To credit this argument, however, would be to permit an obvious bootstrap to relieve putative plaintiffs of their obligations under Rule 23.1. Merely naming disinterested directors as defendants does not allow the prosecutor of a derivative suit to avoid his duty to make a demand on them. [citation omitted]"

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* *Untermeyer* v. *Fidelity Daily Income Trust*, 580 F.2d 22 (1st Cir. 1978), relied upon by plaintiffs, does not hold to the contrary. The Court of Appeals, on the unusual facts of that case, held merely that demand was futile, and that the District Court erred in *speculating* that the interested directors, who were charged with "self-benefiting" misdeeds, would abstain from voting on the demand to sue themselves. No such issue is presented at bar.

Finally, but perhaps most important, plaintiffs misconceive the purpose and significance of the demand rule. The demand rule is designed to protect against unwarranted shareholder litigation, and to insure that whenever possible the decision to pursue or not to pursue a corporate claim is made by the Board of Directors of the corporation, whose function and responsibility it is to manage the corporation. See, e.g., *In re Kauffman Mutual Fund Actions, supra* (479 F.2d at 263). The demand rule is not a shareholder's permit to sue. Plaintiffs would have this Court rule, in effect, that satisfaction of the demand rule forever vests a shareholder with a proprietary interest in and control of the corporate claim he seeks to assert derivatively. The claim, however, belongs to the corporation, not to one or two of its stockholders, and the legally elected directors are the ones who must be able to assert continuing control over the claim.

The demand rule cannot and does not paralyze a corporation from acting or reacting to evolving circumstances after the case has been commenced. The demand rule comes into play only at the time the derivative action is commenced. *Cramer* v. *General Telephone & Elec. Corp.*, 582 F.2d 259, 276 (3d Cir. 1978).

The cases have always recognized that, so long as they act in good faith and independently, the corporation's directors have the right and power, based upon subsequent developments, to take over the claim and pursue or end it, as the directors deem best for the corporation.

Thus, the corporation itself took over the claim in *In re Penn Central Securities Litigation*, 335 F.Supp. 1026, 1040 (E.D.Pa. 1971) and in the underlying litigation which gave rise to *Alleghany Corp.* v. *Kirby*, 344 F.2d 571 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966). And

the directors were permitted to make direct contact with the alleged wrongdoers to settle and discontinue the underlying claim, notwithstanding the pendency of the derivative action in *Wolf* v. *Barkes*, 348 F.2d 994, 997 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965) and *Goodwin* v. *Castleton*, 19 Wash. 2d 748, 757-58, 144 P.2d 725, 729-30 (1944). And a quorum of disinterested directors was permitted to take other corporate action to remove the basis for the claim and thus compel termination of a derivative action against insiders in *Blish* v. *Thompson Automatic Arms Corporation*, 30 Del.Ch. 538, 583, 64 A.2d 581, 604 (1948). See also: *Meyer* v. *Fleming*, 327 U.S. 161, 167-68 (1946); *Nelson* v. *Pacific Southwest Airlines*, 399 F.Supp. 1025, 1031 (S.D.Cal. 1975).

The rule proposed by plaintiffs would allow one or two dissentient stockholders to force the corporation on an unalterable course regardless of whether that course continues to be in the best interests of the corporation. Such a rule might unwisely commit the corporation to action not in its best interests. As the Court stated in *Goodwin, supra* (19 Wash. 2d at 763-64, 144 P.2d at 732-33):

> "The mere circumstances that a lone stockholder, or a group of such individuals, has initiated a derivative action, and has alleged the existence of facts entitling him or them to maintain the suit in place of the corporation, do not of themselves establish the propriety of the action or the necessity for its continued maintenance, for otherwise, by this device the corporation, its officers, and directors, and the majority stockholders would at once be conclusively shorn of their powers of management and discretion in the conduct of those affairs which are of vital concern to the corporation and all its stockholders.
>
> * * *

> " . . . Their right in such matters is not completely forestalled by the mere fact that a single stockholder or a group of stockholders has taken the initiative by instituting a derivative action."

In *Blish, supra* (30 Del. Ch. 538, 64 A.2d 581), two years after a derivative action had been filed to nullify certain transfers of stock to two of the inside directors, a quorum of disinterested directors met and voted to ratify the issuance of the shares, thereby mooting and effecting termination of the derivative action. The Supreme Court of Delaware upeld the action of the distinterested directors which had the effect of terminating the derivative action even though the action had been validly commenced and was not frivolous, stating (30 Del. Ch. at 583, 64 A.2d at 604):

> "The contention made by the appellant that the . . . ratification was ineffective, since such occurred subsequent to the day that this suit was instituted below, is without merit. Courts generally look with apprehension upon ratification of previous corporate acts after an action has been instituted questioning the validity of such acts. However, in the absence of fraud, subsequent action by the Board within director authority will be held to be valid."

The relationship of the demand rule to the business judgment power of the directors was properly recognized in *Nelson, supra* (399 F.Supp. 1025). Whether a demand must be made is determined at the outset of the action, i.e., when the claim is first asserted. The fact that the composition of the Board may change thereafter, so that demand would no longer be futile, does not necessarily

require the shareholder plaintiff to make a new demand.* However, the new directors can, on their own initiative, determine the future course of the action (399 F. Supp. at 1031):

> ". . . the plaintiffs are not required to seek to have the new directors intervene in the suit. Though the plaintiffs may be bound by the decision of the board, it is the board itself which must initiate such activity. [citation omitted]"

At bar, of course, the directors did themselves initiate the activity at issue, i.e., the motion to dismiss.

Reply to Point III

Plaintiffs argue, in Point III A, that under Delaware law a minority of directors cannot prevent commencement of a derivative action, and, therefore, should not be permitted to effect a termination of a derivative action, i.e., that "Delaware precedents are the same as under Federal Rule 23.1" (Respondents' Brief, pp. 35-36).** None of the cases cited by plaintiffs at pp. 35-36 of their brief deals with the business judgment powers of directors. Applicable Delaware authority clearly recognizes the power of a quorum of the directors to manage the affairs of the corporation, including the power to make decisions to prosecute or cause the termination of litigation on behalf of the corporation. *McKee* v. *Rogers,* 18 Del. Ch. 81, 85-86, 156 A. 191, 193 (Ch. 1931). See also: *Blish* v. *Thompson*

* If, however, the plaintiff files an amended complaint or seeks to assert a new claim after the composition of the Board has changed, a new demand is necessary. See, e.g., *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir.), *cert. denied,* 414 U.S. 1104 (1973).

** As shown *supra,* Reply to Point II, plaintiffs are in error in their argument that satisfaction of Rule 23.1 by a derivative plaintiff forever after renders directors powerless to act in the best interests of the corporation.

Automatic Arms Corp., 30 Del. Ch. 538, 583, 64 A.2d 581, 604 (1948).

Plaintiffs also argue, in Point III A, that under Delaware law directors may not ratify a fraud (Respondents' Brief, pp. 36-38). This argument misses the point. First, there was no fraud here, but only an investment loss in the ordinary course of operations. Second, the directors did not ratify anything; they exercised their business judgment in what they believed to be the best interests of Fundamental. The courts have repeatedly rejected this argument advanced by plaintiffs, and recognized that

> "The question whether it is good judgment to sue is quite apart from the question of ratification."

S. Solomont & Sons Trust, Inc. v. *New England Theatres Operating Corp.,* 326 Mass. 99, 111, 93 N.E.2d 241, 247 (1950). Accord: *Kessler & Co.* v. *Ensley Co.,* 129 F. 397, 399 (C.C.N.D. Ala. 1904); *Gall* v. *Exxon Corp.,* 418 F.Supp. 508, 518n.18 (S.D.N.Y. 1976). The District Court also correctly drew this distinction (A.19), and the Court of Appeals did not disturb this portion of the District Court's opinion.*

* The plaintiffs' argument, moreover, overlooks the numerous cases where the courts have upheld the power of disinterested directors not to pursue litigation, even though arguably nonratifiable conduct was at issue. See, e.g., *Brody* v. *Chemical Bank,* 517 F.2d 932 (2d Cir. 1975) (involving federal securities acts and fraud claims); *Alleghany Corp.* v. *Kirby,* 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed,* 384 U.S. 28 (1966) (involving fraud claims); *Swanson* v. *Traer,* 249 F.2d 854, 859 (7th Cir. 1957) (involving fraudulent conspiracy); *Gall* v. *Exxon Corp.,* 418 F.Supp. 508, 516 (S.D.N.Y. 1976) (involving illegal payments); *Goodwin* v. *Castleton,* 19 Wash.2d 748, 764, 144 P.2d 725, 733 (1944) (involving fraud claims). Plaintiffs' reliance on *Mayer* v. *Adams,* 37 Del.Ch. 298, 141 A.2d 458 (1958), is misplaced. The only issue presented in *Mayer* was the necessity for a demand on *shareholders;* the role of *directors* in deciding whether to pursue proposed derivative claims was not an issue. Finally, plaintiffs' use of Professor Folk (Respondents' Brief, p. 39 n.*) is misleading: he was obviously talking about fraud in the exercise of business judgment, not fraud in the underlying claim. See Folk, The Delaware General Corporation Law: A Commentary and Analysis 76 (1972).

Plaintiffs argue, in Point III B, that federal law governs the power of the directors to exercise their business judgment to terminate derivative litigation (Respondents' Brief, pp. 39-42). As indicated in our prior brief, we believe that under the principles of *Santa Fe* and *Cort* state law should be applied here. However, it matters not—the result is the same under federal or state law: a quorum of disinterested directors has the power to terminate stockholder derivative litigation which it, in good faith, determines to be contrary to the best interests of the fund and its shareholders. See Reply to Points I and II, pp. 4-16 and SEC Brief, pp. 20-23.

Reply to Point IV

Plaintiffs argue, in Point IV A, that Rule 23.1 requires notice to shareholders and judicial approval of the dismissal of this action (Respondents' Brief, pp. 43-50)—this is erroneous because the Rule 23.1 notice and judicial approval procedures do not apply to this situation.

Plaintiffs have misconceived the purpose of Rule 23.1 and the pertinent case law. The notice and judicial approval provisions of Rule 23.1 are intended to protect shareholders against unfair and collusive settlements of derivative suits; they do not apply to a *contested* dismissal as at bar. See, e.g., *Wolf* v. *Barkes*, 348 F.2d 994, 996-97 (2d Cir.), *cert. denied*, 382 U.S. 941 (1965); *Katz* v. *Aspinwall*, 342 F.Supp. 286, 288 (N.D. Ala. 1971), *aff'd*, 459 F.2d 1045 (5th Cir.), *cert. denied*, 409 U.S. 1000 (1972); *Daugherty* v. *Ball*, 43 F.R.D. 329, 335 (C.D. Cal. 1967); *Marcus* v. *Textile Banking Co.*, 38 F.R.D. 185, 187 (S.D.N.Y. 1965). See also: *Hutchinson* v. *Fidelity Inv. Ass'n*, 106 F.2d 431, 436 (4th Cir. 1939); *Moreland* v. *Rucker Pharmacal Co., Inc.*, 63 F.R.D. 611, 614-15 (W.D.

La. 1974); Miller, *Problems of Giving Notice in Class Actions*, 58 F.R.D. 313, 331 (1973); Simeone, *Procedural Problems of Class Suits*, 60 Mich. L.Rev. 905, 934 (1962).

As the Court stated in *Marcus, supra* (38 F.R.D. at 187), in refusing to order notice of a dismissal of a derivative suit for lack of jurisdiction:

> " 'The purpose of the provision is the protection . . . against the unjust or unfair settlements in case a plaintiff who starts the action becomes faint-hearted before its completion or secures satisfaction of his individual claims by compromise.' [citation omitted]"

Similarly, Professor Miller has explained with regard to Rule 23(e) (58 F.R.D. at 331):

> "Another exception to the mandatory notice requirement in Rule 23(e) occurs when the dismissal is not voluntary. Inasmuch as an involuntary dismissal presumably cannot involve collusion or benefit the representative plaintiffs at the expense of the remaining class members, the protection afforded by giving notice to the absentees is not required."

Rule 23(e), as noted below,* contains the identical provisions as Rule 23.1 regarding notice and judicial approval.

Wolf, supra (348 F.2d 994), illustrates this point. After a shareholder had brought a derivative action against corporate officers and directors for violations of the federal

* Originally, Rule 23 covered both class and derivative actions. In 1966 Rule 23 was amended and a new rule—Rule 23.1—was adopted to deal solely with derivative actions. Rule 23.1 did not change the provisions dealing with dismissal or compromise of shareholders' actions; the last sentence of Rule 23.1 is virtually identical to new Rule 23(e) and essentially continues the law under prior Rule 23(c). See 3B Moore's *Federal Practice* ¶ 23.80[1] at 23-505 (2d ed. 1978).

securities laws, the corporation negotiated settlements directly with some of the defendants. The derivative plaintiff moved to enjoin the settlements, claiming that they were legally ineffective without notice to the stockholders and approval by the Court pursuant to then Rule 23(c) [now Rule 23.1]. The Court of Appeals affirmed the denial of an injunction on the ground that the judicial approval and notice requirements of the rule did not apply, since the rule was intended to protect against *voluntary* dismissals by shareholder plaintiffs, not *involuntary* dismissals over their objection. Judge Friendly wrote (348 F.2d at 996-97):

> "... If we go behind the letter to the prime 'mischief and defect' the rule was intended to prevent, to wit, 'private settlements under which the plaintiff stockholder and his attorney got the sum paid in settlement, and the corporation got nothing,' [citation omitted], the instant case likewise is not within it.
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> * * *
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> ". . . When the acquiescence of a derivative plaintiff to a dismissal or a consent judgment has in effect been purchased by the defendants, the supposed vigorous champion of the shareholders at large has been retired; far from policing the disposition of the corporate claim, he may well assist in seeing that the news does not leak out to stir other shareholders to inquiry. No such silencing of the derivative plaintiff occurs when the corporation settles out of court with some of the defendants. Indeed, he is the very person most likely to challenge the settlement. . . ." *

* Judge Friendly also noted (348 F.2d at 997 n.4):

> "The SEC urged Congress to provide in the Investment Company Act of 1940 that such companies be forced to seek court approval before settling claims against 'insiders' that could be the target of derivative suit; the provision was not enacted. [citations omitted]"

The same considerations apply at bar, where plaintiffs have vigorously opposed the dismissal.

Auerbach v. *Bennett*, 64 A.D. 2d 98, 408 N.Y.S.2d 83 (2d Dept. 1978), is mischaracterized by plaintiffs (Respondents' Brief, p. 50). First, as a state court case, *Auerbach* did not deal with Rule 23.1. Moreover, in the very next sentence following the quotation by plaintiffs, the Court added (64 A.D.2d at 108, 408 N.Y.S.2d at 88):

> "That is not to say that after the usual discovery and deposition stages of the action have been completed, summary judgment might not be the appropriate vehicle to terminate the action when the record shows that the disinterest of the directors was not refuted, the underlying facts were thoroughly investigated and cogent reasons existed in support of the decision of the committee."

The Court held merely that (*id.*):

> "On *this* record, and at *this* stage, we think that summary judgment should not have been granted." (emphasis supplied)

The other cases under Rule 23.1 cited by plaintiffs are inapposite. All involved applications by plaintiffs for *voluntary* dismissals of derivative actions as a result of negotiated settlements. None of those cases involved *involuntary* dismissals over the vigorous opposition of the derivative plaintiffs.*

* Plaintiffs incorrectly suggest that the cases relied upon by defendants do not apply since "*defendants* here seek dismissal based on the allegedly voluntary act of the minority directors" (emphasis supplied) (Respondents' Brief, p. 44n.*). This obviously misstates the test in those cases, namely whether the *plaintiff* (as the intended guardian of his fellow shareholders' rights) is voluntarily permitting dismissal of the claim, suggesting the possibility of collusion on the part of the plaintiff's counsel.

Plaintiffs argue, in Point IV B, that the SEC's proposal ". . . would wreak havoc with the traditional role of the courts in derivative litigations; it would also result in extensive, time-consuming and litigation-delaying hearings at the behest of minority directors." (Respondents' Brief, p. 50). This is most extraordinary since plaintiffs contend elsewhere in their brief that the District Court should have ordered the mailing of notice to all shareholders and conducted "a full exploration of the relevant circumstances, including the merits" after "discovery on the merits" to weigh the propriety of the dismissal under Rule 23.1 (Respondents' Brief, p. 43).

The SEC correctly recognizes that disinterested directors of a mutual fund do have the power to terminate stockholder derivative litigation (SEC Brief, pp. 20-23). Indeed, as the SEC points out, the business judgment rule is itself "an important shareholder protection device" (SEC Brief, p. 22).

The SEC sets up three factual criteria for recognition of directors' business judgment: (1) the directors must be independent; (2) the directors must be fully informed, and (3) their judgment must be reasonable (SEC Brief, pp. 16-20.) The SEC acknowledges that its first two criteria were met in this case (SEC Brief, pp. 23-24) but suggests that the District Court failed to make an express finding as to its third criterion, i.e. reasonableness.

Although the SEC has suggested that the District Court did not pass upon the reasonableness of the disinterested directors' determination (SEC Brief, p. 8), the second opinion of the District Court specifically referred to the quorum's decision as "their reasoned judgment" (A.35), which is consistent with the test of reasonableness advanced by

the SEC, i.e. whether the directors made "a reasoned determination" (see SEC Brief, p. 20 n.16).*

Moreover, necessarily implicit in the finding of good faith by the District Court was the conclusion that the judgment exercised by the disinterested directors was reasonable.

In any event, the SEC itself agrees that a determination of the reasonableness of the directors' action at bar can readily be made from the record now before this Court. In fact, the SEC states (SEC Brief, p. 25 n.21):

> "Although we suggest a remand, this Court could determine reasonableness if it wishes, because that determination involves only the application of a legal standard to a documentary record."

We do not believe a remand is necessary or appropriate here. No charge is or could be made here that the exercise of business judgment in this case falls "outside the permissible bounds of the directors' sound discretion." See *Cramer* v. *General Telephone & Electronics Corp.*, 582 F.2d 259, 275 (3d Cir. 1978). The record evidence overwhelmingly establishes that the directors made a sound, reasoned business judgment (A.77-79, 131-136, 139-141), that they were fully informed (A.81-116, 118-126, 128-130, 138-139) and that they were entirely independent (A.142-143, 147-150).

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* In *Alleghany Corp.* v. *Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966), the Court of Appeals for the Second Circuit upheld a business judgment not to pursue litigation based upon many of the same factors relied upon by the disinterested directors at bar (344 F.2d at 573 n.1) as a "sound business judgment."

Reply to Point V

Plaintiffs argue, in Point V A, that the disinterested directors were not independent (Respondents' Brief, pp. 56-62). Plaintiffs, alone, are of this view.

The District Court found, after extensive discovery on the issue (A.28):

> "Plaintiffs have not adduced *any* factual support for their conclusion that the members of the disinterested quorum acted other than independently." (emphasis supplied)

The Court of Appeals, which did not disturb the District Court's findings, wrote (A.48):

> "We have no doubt that the five minority directors acted in good faith in all that they did."

The SEC, which examined the record in this case and filed an *amicus* brief wrote (SEC Brief, p. 23):

> "We do not question the district court's finding that the disinterested directors were in fact independent."

Notwithstanding these unanimous judicial and agency findings and views, and notwithstanding the overwhelming record evidence that the disinterested directors of Fundamental were truly independent, plaintiffs continue to carp and cavil about the disinterested directors.

For example, plaintiffs have four pages of charts to show that the disinterested directors were allegedly "hand-picked" by Anchor (Respondents' Brief, pp. 56-59). The fact is that all of the disinterested directors were proposed, in the first instance, by a Directors' Qualifications Com-

mittee, and two of the three members of that committee were, at all times, disinterested directors as that term is defined in Section 2(a)(19) of the Investment Company Act of 1940. Next, all of the disinterested directors were nominated for election by the full board of directors, which, at all times, consisted of a majority of disinterested directors. Finally, all of the disinterested directors were elected by the stockholders as their lawful representatives (A.142-143). The root of the error of plaintiffs' position is their mistaken notion that merely by naming a disinterested director a defendant in a derivative action, he or she, without more, is disqualified, both prospectively and retrospectively, from functioning as a director. If this were the rule, plaintiffs in derivative actions could control the corporate destiny without any restraint by merely naming all directors as defendants.

Plaintiffs also contend that the five disinterested directors were not independent because of "a long history of social and business relationships with a number of defendants" (Respondents' Brief, p. 59). This is an utter distortion, as a reading of the record shows. The District Court made this finding (A.28):

> "Although each of the minority directors knew someone on the Board at the time he or she was nominated, the relationships which existed between the minority directors and the defendant directors were *de minimis*. . . ."

At another point in their brief, plaintiffs assert that "Each member of the quorum had been screened, selected and nominated for office by Anchor and the individual defendants who, as majority directors, at all times had the absolute power to effect their removal." (Respondents Brief, p. 8). Plaintiffs offer no citation of authority

—either record or legal—for these assertions. The fact is that Anchor did not screen, select or nominate any director (A.142-143) and neither Anchor nor any combination of the so-called majority directors had any power to remove the so-called minority directors—all directors served, in accordance with law, until their terms expired and their successors were duly elected and qualified. Delaware Corporation Law, § 141 (b) and (k), Del. Code tit. 8, § 141(b) and (k) (1975).

Plaintiffs also argue, in Point V B, that the action has "merit" (Respondents' Brief, p. 63). The disinterested directors and their special counsel, Judge Fuld, found otherwise (A.82), but the important point is that they carefully *considered* the merits, as the District Court found (A. 36).* Even assuming, *arguendo*, that the action has "merit", that is only one of many factors to be considered in arriving at a sound business judgment. And the law is, and always has been, as stated in *Cramer, supra* (582 F.2d at 275):

> "Even if a particular suit has some merit, the litigation costs and the adverse effect on the business relationship between the corporation and the potential defendant might outweigh any potential recovery in the lawsuit."

* Plaintiffs erroneously contend that Judge Fuld "overlooked" *Matter of Winfield & Co., Inc.* (Respondents' Brief, p. 63). First, there is no evidence in the record that Judge Fuld failed to consider that case. Second, that case is not in point: it was an uncontested SEC enforcement proceeding involving an investment adviser who, in recommending purchase of restricted securities by the fund, relied on unsubstantiated representations of other persons, described by him as "research sources" but who, in fact, had a substantial economic interest in such restricted securities. No such facts are present here: Anchor relied, among other things, on the "Prime" rating of Penn Central by NCO (a subsidiary of Dun & Bradstreet), the foremost independent commercial paper rating agency in the country (A.86, 122). In addition, Anchor was knowledgeable about Penn Central since Penn Central Company had been a recent equity holding of Fundamental (A.125). Finally, since *Matter of Winfield & Co., Inc.*, was an SEC enforcement proceeding, no finding of *scienter* was necessary for liability. To the contrary, in a private damage action such as this one, as Judge Fuld correctly concluded, proof of "fraudulent intent" is essential to recovery (A.94).

This Court long ago stated in *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903):

> "The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right."

Plaintiffs make numerous overstatements and misstatements throughout their brief with respect to the merits. For example, plaintiffs assert that the Court of Appeals made "a further *finding* that the plaintiffs' claims were substantial and *meritorious*" (emphasis supplied) (Respondents' Brief, p. 10). This is false. The Court of Appeals nowhere *found* or even stated that plaintiffs' claims were *meritorious*. The Court of Appeals said only ". . . we cannot say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses." (A.43) This hardly constitutes a finding of meritoriousness of plaintiffs' claims by the Court of Appeals.

Plaintiffs also misleadingly assert that Anchor "violated two out of the three investment guidelines which it had established to safeguard the Fund", i.e., the 10% guideline and the buy-back guideline (Respondents' Brief, p. 3). This is false. As to the 10% guideline, Fundamental purchased $20 million out of a total of $200 million of Penn Central commercial paper outstanding, and, thus, was within its guideline (A.109-110, 122). And, as to the buy-back guideline, Anchor believed on the basis of its prior talks with Goldman, Sachs & Co., which had always bought back paper previously, that it had such an understanding (A.84, 121-122). Goldman, Sachs & Co., under the pressure of the situation, simply failed to honor its commitment in this case (A.124).

Other examples of overstatement and misstatement by plaintiffs with respect to the merits abound. However, since they are essentially an attempt to re-argue facts found by the District Court, and do not affect the fundamental issue before this Court, no further response will be made in this brief.

Plaintiffs next argue, in Point V C, that the minority directors were misinformed by Mr. Haire and by Mr. Souther (Respondents' Brief, pp. 68-73). The District Court made express findings to the contrary.

As to Mr. Haire, the District Court found (A.35):

> "The court is of the opinion that Haire's statements are neither inconsistent nor misleading. His assertions only indicate that he believed it would have been difficult, but not impossible, for Anchor to have continued its service to the Fund faced with this lawsuit. The affidavit of the disinterested quorum chairman shows only that the minority directors reached a different conclusion: that prosecution of the suit 'would necessarily cause the Fund to seek to obtain a different investment adviser immediately.' "*

As to Mr. Souther, the District Court found that his participation was "equally innocent" (A.32). The full findings as to Mr. Souther by the District Court are set forth at A.32-33 and will not be reprinted here in the interest of brevity. Plaintiffs now also claim that a memorandum prepared for the disinterested directors, at their request, by Mr. Souther's firm (A.158-161), was "biased"; however, the memorandum is factually and legally correct and plaintiffs did not and could not demonstrate otherwise.

* The claim that Mr. Haire "misled" the disinterested directors is exposed as baseless by a review of the discovery proceedings. Plaintiffs read Mr. Haire's statement to Mr. Stephens, who testified flatly "I *differ* with Mr. Haire on his conclusion." (Stephens Tr. 116-119.) Mr. Haire had one view as to whether Anchor could continue to act; the disinterested directors had another view. Mr. Haire did not mislead anyone about anything.

The final argument raised by plaintiffs in Point V D, to wit, that because Anchor is no longer the investment adviser, the continued prosecution of this action cannot possibly injure Fundamental, has been dealt with earlier in this Reply Brief at pp. 3-4. The adversary relationship was just one of many factors considered and relied upon by the disinterested directors in reaching their conclusion that this derivative litigation was contrary to the best interests of Fundamental and its shareholders and should be terminated. The numerous other factors are set forth in the moving affidavit of Mr. Kendall (A.77-79), the minutes (A.137-141) and the letter of Mr. Stephens (A.131-136).

* * *

Respondents' Brief is, in sum, a "skillful assemblage of suspicions, surmises and conjectures."* Reflection upon the true issue in this case leads one inescapably back to this proposition: plaintiffs and the Court of Appeals would have this Court rule that disinterested directors of a mutual fund, who constitute a quorum and have been found to be truly disinterested and independent, are incapacitated, *as a matter of law,* from exercising their business judgment to terminate a stockholder's derivative action they find to be contrary to the best interests of the fund and its shareholders. The *per se* disqualification of the disinterested directors is in conflict with the intent of Congress as expressed in the Investment Company Act of 1940 and does violence to sound and logical principles of corporate governance.

* *Marco* v. *Bank of New York,* 272 F. Supp. 636, 640 (S.D.N.Y. 1967), *aff'd,* 398 F.2d 628 (2d Cir. 1968).

CONCLUSION

The judgment of the Court of Appeals should be reversed and the Complaint should be dismissed.

Respectfully submitted,

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January 8, 1979

IN THE

Supreme Court of the United States

OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*,

Petitioners,

v.

HOWARD M. LASKER, *et ano.*,

Respondents.

BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE*

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BRIEF OF INVESTORS DIVERSIFIED SERVICES, INC., AS *AMICUS CURIAE*

INTEREST OF THE *AMICUS CURIAE*

Investors Diversified Services, Inc. ("IDS"), files this brief as *amicus curiae* with the consent of all parties, urging that the judgment of the Court of Appeals for the Second Circuit be reversed. The decision of the Court of Appeals below is of substantial concern to IDS, the investment adviser to the nation's largest mutual fund complex.[1] The decision held as a matter of law that a quorum of investment company (mutual fund) independent directors may not terminate a shareholder derivative suit, allegedly brought for the fund's benefit, despite such quorum's unanimous determination that prosecuting the action would not be in the fund's best interests. At the very least, this decision places mutual funds in a uniquely disadvantageous position when their independent directors attempt to decide such questions in the best interests of all of their shareholders.

[1] IDS is the investment adviser to ten open-end mutual funds. IDS-associated mutual funds have assets approximating $5 billion, held on behalf of over one million shareholder accounts.

The District Court upheld the power of independent mutual fund directors to act on shareholder derivative claims, but the Court of Appeals elected to reverse on grounds which were, at least in part, significantly different from those advanced by the respondent shareholders. Thus, the impact of the reasoning employed by the court below was largely unanticipated.

In this brief, IDS seeks to bring to the Court's attention the pervasive ramifications of the decision below to the mutual fund industry and to the federal court system, and to emphasize that a resolution of now-conflicting application of rules for corporate governance is of critical importance to the functioning of the entire mutual fund industry, and, indeed, to corporations generally.

OPINIONS BELOW

The opinion of the Court of Appeals, *Lasker* v. *Burks*, is reported at 567 F.2d 1208 (2d Cir. 1978). The opinion appears in the Appendix filed in this Court by Harry G. Burks, Jr., *et al.* ("Petitioners"). (A. 39-48).[2] Also set forth in that Appendix are the opinions of the United States District Court for the Southern District of New York dated October 17, 1975 (as amended), reported at 404 F. Supp. 1172, and January 7, 1977, reported at 426 F. Supp. 844. (A. 5-38).

QUESTIONS PRESENTED

1. Whether the federal policy respecting mutual funds as expressed in the Investment Company Act preempts long-established state corporation law authorizing independent directors to determine whether the maintenance of a shareholder derivative action is in the best interests of the corporation.

[2] "A." references are to the Appendix filed herein pursuant to Rule 36 of this Court.

2. Whether the policies embodied in the business judgment rule and the demand requirement of Rule 23.1 of the Federal Rules of Civil Procedure reflecting a strong policy preference for intracorporate resolution of disputes concerning pursuit of possible corporate claims should be abrogated by a judicially-created irrebuttable presumption, which cannot logically be confined to the mutual fund context, that the independent members of a mutual fund board of directors can never fairly evaluate a possible claim against the other directors.

3. Whether the independent members of the board of directors of a mutual fund, whose presence on such board is specifically mandated by the Investment Company Act so that they may serve as "watchdogs" for the interests of the fund and its shareholders, should be under any special disability in deciding whether or not the fund's best interests are served by pursuing derivative claims brought by a shareholder allegedly for the fund's benefit.

STATUTES AND RULES INVOLVED

The statutes and rules involved in this case are Sections 141(a), 141(b) and 144(a) of the Delaware General Corporation Law, 8 Del. Code §§ 141(a) and (b), 144(a) (1975), Sections 10(a), 36(a) and 36(b) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-10(a), 80a-35(a) and (b) (1970), and Rule 23.1 of the Federal Rules of Civil Procedure. These statutes and rules are set forth in full in an Addendum at the end of this brief.

STATEMENT OF THE CASE

Fundamental Investors, Inc. ("Fundamental"), was chartered as a corporation by the State of Delaware on October 17, 1932, for the purpose of engaging in the mutual fund business. By 1969, Fundamental had over 90,000

shareholders and a portfolio of approximately $1 billion. Between November 26 and December 8, 1969, it purchased, as a short-term investment, $20 million of 270-day notes issued by the Penn Central Transportation Company ("Penn Central"). Because of Penn Central's bankruptcy in June 1970, the notes were not paid at maturity.

The notes had been sold to Fundamental by Goldman, Sachs & Co. ("Goldman, Sachs"), a leading commercial paper dealer. On November 4, 1970, Fundamental and others brought suit against Goldman, Sachs, claiming that it had violated various antifraud provisions of the federal securities laws and seeking rescission of the Penn Central note transactions.

In early February 1973, more than three years after Fundamental had purchased the Penn Central notes, two of Fundamental's more than 90,000 shareholders (hereinafter "plaintiffs") commenced the instant derivative action, allegedly on behalf, and for the benefit, of Fundamental. No demand was made upon the directors before the complaint was filed. Named as defendants were Fundamental, its investment adviser Anchor Corporation ("Anchor"), and all of Fundamental's ten directors serving in 1969 when the notes were purchased.[3]

The complaint sought damages for the defendants' alleged violations of Sections 13(a)(3) and 36 of the Investment Company Act of 1940 [15 U.S.C. §§ 80a-13(a)(3) and 80a-35], and Section 206 of the Investment Advisers Act (15 U.S.C. § 80b-6). It also alleged that certain defendants breached common law fiduciary duties and the investment advisory contract. The principal thrust of the factual allegations was that the investment adviser made an insufficient examination of Penn Central's financial condition

[3] The directors were: Harry G. Burks, Jr., Edward B. Burr, Thomas F. Chalker, John R. Haire, Harvey E. Hopkins, S. P. Hutchison, Donald L. Kemmerer, A. S. Mike Monroney, Charles F. Phillips, and Jeptha H. Wade.

prior to purchase of the notes. Further proceedings in the derivative action were stayed by the District Court pending resolution of Fundamental's lawsuit against Goldman, Sachs.

On July 9, 1974, after completion of discovery and one day before the scheduled commencement of trial, Fundamental settled its claims against Goldman, Sachs. Goldman, Sachs took back the Penn Central notes, paid Fundamental $5.25 million in cash, and assigned to Fundamental a 73.75% interest in the proceeds of the notes in the Penn Central reorganization proceedings.[4]

At its next regular meeting after settlement with Goldman, Sachs, held on July 24, 1974, Fundamental's board reviewed the status of plaintiffs' suit. The board decided that the five directors who were not named as defendants would act as a quorum of the board, pursuant to Section 141 of the Delaware General Corporation Law and Fundamental's By-laws, to determine what position Fundamental should take regarding this action.[5] The remaining directors

[4] On March 9, 1978, the United States District Court for the Eastern District of Pennsylvania preliminarily approved a Penn Central plan of reorganization, *see The Wall Street Journal*, March 10, 1978, at 37, col. 1; *id.*, October 25, 1978, at 34, col. 3. As part of the plan, holders of Penn Central notes will receive, in exchange for their notes and accrued interest thereon to December 31, 1977, shares of common stock of the reorganized company and certificates of beneficial interest in certain proceeds of the sale of certain assets of Penn Central. Fundamental's interest in the Penn Central notes arising from the settlement with Goldman, Sachs should entitle it, we estimate, to approximately 192,000 shares of common stock and certificates of beneficial interest with a face value of approximately $6.6 million. The common stock is presently trading publicly at a price of approximately $16 per share. Thus, Fundamental's settlement with Goldman, Sachs will result in recovery of at least an additional $3 million, without regard to the market value of the certificates of beneficial interest, in which trading has not yet begun. See *id.*, November 9, 1978, at 7, col. 1.

[5] Five of Fundamental's directors assumed office after the purchases of the Penn Central notes and were thus not named as defendants.

agreed to take no part whatsoever in the independent directors' determination. (A. 67-70).

These five directors (hereinafter the "independent quorum"), statutorily disinterested persons under the Investment Company Act [15 U.S.C. §§ 80a-2(a)(19) and 80a-10(a)], were: Louis F. Laun, elected in 1971; Mary S. O'Connor, elected in 1972; Dr. Beryl Robichaud and William J. Stephens, elected in 1973; and Leon T. Kendall, elected in 1974.

The independent quorum retained special counsel, Hon. Stanley H. Fuld, former Chief Judge of the State of New York, to advise them concerning Fundamental's possible claims against its investment adviser and the other defendants. Special counsel had no previous connection with any of the parties.[6] Judge Fuld studied plaintiffs' complaint, the proceedings in the action against Goldman, Sachs, and the files of Fundamental and its investment adviser relating to the Penn Central note transactions; he interviewed officers and employees of Fundamental and the adviser; and he analyzed the facts and the law. On December 5, 1974, special counsel reported to the independent quorum in a comprehensive 40-page legal and factual memorandum, concluding that there was no violation by the defendants herein of any statutory, common law or contractual duty to Fundamental.

The directors constituting the independent quorum met, reviewed the subjects raised by special counsel's memorandum, discussed the various alternatives open to Fundamental, and posed additional questions to special counsel, who sent them a supplemental memorandum on December 18, 1974. That memorandum pointed out that the question

[6] In the District Court, plaintiffs claimed that the Secretary of Fundamental, acting under the direction of defendant Haire, retained special counsel. Judge Werker rejected this contention, finding that Judge Fuld was retained by the independent quorum of directors. 426 F. Supp. at 850. The Court of Appeals did not disturb this finding.

of whether plaintiffs' claims were to be enforced in the courts was, like other matters concerning the corporation's best interests, properly committed to the discretionary business judgment of the independent quorum.

The independent quorum next held a series of discussions and special meetings to consider special counsel's memoranda. On January 6, 1975, they unanimously determined that prosecution of plaintiffs' suit was contrary to the best interests of Fundamental and its shareholders (other than the two plaintiffs). The factors relied upon by the independent quorum included the dim prospects of recovering from any defendant amounts beyond those already paid by Goldman, Sachs; special counsel's opinion that there was no real merit to the claims and little likelihood of success; the substantial litigation expense to Fundamental; and the major disruption of Fundamental's affairs which would accompany litigation, including the probability that Fundamental would have to replace its investment adviser. *See* 404 F. Supp. at 1176-77 (S.D.N.Y. 1975) (Werker, J.).

On instructions from the independent quorum, litigation counsel for Fundamental thereafter moved to dismiss plaintiffs' action as not being in the best interests of the corporation. The District Court held that the independent quorum of Fundamental's board had complete power under the business judgment rule to bar prosecution of this action if the directors who made the decision were truly disinterested and independent. *Id.* at 1180.

Plaintiffs raised a factual issue of whether the quorum was disinterested and independent, and the District Court accordingly held further proceedings related solely to that issue. Depositions of the members of the independent quorum revealed that none of them is related to any defendant by blood or marriage, that none is or ever was a business partner of any of the defendants, that none has or had any business or professional relationships with or interest in the investment adviser, and that none had any

close personal friendship with any of the defendants, though four were acquainted with one or more of the defendants at the time they were nominated to the board. (R. 209A-213A; R. 479A-480A; R. 529A-534A; R. 649A-655A; R. 671A-674A; R. 690A; R. 812A; R. 916A-917A; R. 919A-920A; R. 937A; R. 989A-990A).[7] Two of the five members of the quorum—Laun and O'Connor—were elected to Fundamental's board well before the *Lasker* action was commenced in February 1973. (R. 173A-179A). Further, no defendant mentioned the *Lasker* action to any of these five directors before, at the time of, or in connection with, their nominations to the board of directors. (R. 527A-529A; R. 686A-688A; R. 704A; R. 784A-786A; R. 854A-855A; R. 943A-948A; R. 990A). Finally, these directors testified that the merits of the *Lasker* action were not considered by the board until its July 24, 1974 meeting following settlement of the action against Goldman, Sachs. (R. 252A-253A; R. 657A-658A; R. 687A-688A; R. 785A-787A; R. 851A-852A; R. 949A-959A).

Accordingly, after exhaustive discovery and argument on the question of the quorum's activities and independence, the District Court granted Fundamental's motion to dismiss on January 7, 1977, finding that plaintiffs "have not adduced any factual support for their conclusion that the members of the disinterested quorum acted other than independently." 426 F. Supp. 844, 849 (S.D.N.Y. 1977).

Plaintiffs appealed the dismissal of their complaint to the Court of Appeals for the Second Circuit. On January 11, 1978, that court reversed, holding that the independent directors lacked power to terminate plaintiffs' derivative action. A petition for rehearing *en banc* was denied on March 9, 1978. Defendants timely filed a petition for a writ of certiorari with this Court on June 2, 1978, and the petition was granted on October 2, 1978.

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[7] "R." references are to the three-volume printed Appendix filed in the Court of Appeals for the Second Circuit. The page numbers refer to the consecutive numbers stamped on the pages of that printed Appendix.

SUMMARY OF ARGUMENT

The decision of the Court of Appeals for the Second Circuit in this case incorrectly disregarded controlling principles of Delaware corporate law governing the powers of corporate directors. The court below held that an independent quorum of mutual fund directors found by the District Court to be "truly independent" was disqualified, as a matter of law, from deciding to terminate a shareholder derivative suit, allegedly brought for the corporation's benefit, which it had determined was not in the best interests of the corporation, despite the fact that the independent directors who comprised the quorum made such determination in "good faith" after extensive consultation with independent special counsel.

The business judgment rule is a well-settled principle of Delaware law—and of state law generally—which places the responsibility for the management of a corporation, including decisions as to whether or not to pursue a possible corporate claim through litigation, in the hands of independent directors duly elected by the corporation's shareholders. The District Court honored this principle, but the Court of Appeals regarded it as irrelevant. The result reached below, if applied generally, threatens the basic structure of intracorporate governance by permitting two shareholders among 90,000 to impose their will upon the corporation by continuing to maintain this litigation, ostensibly on behalf of the corporation, in spite of the informed opposition of the independent quorum which was duly charged under Delaware law with the responsibility to assess the proposed claims.

Although the Court of Appeals purported to find support for this extraordinary result in the fact that respondents were presenting claims involving federal policies, such a basis for ignoring state corporate governance law is clearly inconsistent with a long line of decisions of this Court.

The most recent such decision, *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 479 (1977), holds that such state law will be displaced only when federal law "expressly" requires it—a test not satisfied here.

The Court of Appeals also buttressed its decision to ignore settled state law by creating an irrebuttable presumption of law that the independent members of a board of directors are incapable of passing fairly upon proposed corporate claims directed in part at their fellow directors, 567 F.2d at 1212, and by referring to "the unique nature of the investment company and its symbiotic relationship with its investment adviser." *Id.* at 1212 n.14. Neither of these rationales withstands analysis.

The creation of this presumption is especially unwise when our legal system is placing increasing reliance upon the addition of significant numbers of independent directors—such as those who acted in this case—to corporate boards. These directors should be given the chance to serve their monitoring function, not stripped of that opportunity on the basis of an irrebuttable presumption that may frustrate this desirable trend.

Further, the presumption employed by the Court of Appeals to ignore the independent directors' decision cannot logically be confined to corporations which happen to be mutual funds or to cases in which the deciding directors constitute a significant percentage of the board, albeit a minority. Thus, unless reversed, the decision below has the potential to expand greatly shareholder derivative litigation (involving both mutual funds and other public corporations) in the federal courts by undermining both the business judgment rule and the requirement of Rule 23.1 of the Federal Rules of Civil Procedure of a demand on directors prior to the commencement of derivative litigation. Since shareholder plaintiffs will, on this analysis, now be able to maintain derivative suits in spite of the contrary judgment of an independent quorum of

the board, the decision below reverses the traditional preference of both the business judgment rule and Rule 23.1 for intracorporate (rather than judicial) determination of whether or not to sue on proposed corporate claims.

The Court of Appeals' decision is especially unwarranted since the subjective factors relied upon below in creating this new rule of presumptive disqualification provide neither factual nor logical support for such a result. Even that court's effort to limit the reach of its presumption conflicts with the basic policy underlying the business judgment rule. In sharp contrast, the District Court's careful evaluation of the evidence relating to the independence and good faith of the deciding directors was not only consistent with the decided cases, but also assured that no unfairness in fact resulted from giving effect to the independent quorum's decision to terminate this suit.

Finally, to the extent that the Court of Appeals sought support for its decision in the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, it drew from the legislative materials precisely the opposite conclusion from that intended by Congress, which has attempted to enhance and strengthen the role of mutual fund independent directors as "watchdogs" for the interests of all shareholders. The decision below conflicts not only with Congressional intent, but also with a leading decision of the Court of Appeals for the First Circuit which properly interpreted the Investment Company Act to uphold the right and duty of mutual fund independent directors to determine whether the pursuit of shareholder derivative claims is in the best interests of the fund. Moreover, the decision below conflicts with previous decisions of the Court of Appeals for the Second Circuit that reached results analogous to that in the First Circuit. If allowed to stand, the decision below significantly limits the opportunity of such directors to exercise their responsibility in an important area of mutual fund management.

ARGUMENT

I.

The Decision of the Court of Appeals Improperly Preempts Basic State Law Principles Concerning the Management of Corporate Affairs

Simply stated, the issue presented here is whether the independent quorum of directors, acting on behalf of Fundamental and all of its shareholders, had the power to decide that the derivative claims proposed by two of the fund's 90,000 shareholders should not be pursued. The District Court, relying on basic principles of state corporate law, held that such power existed and dismissed plaintiffs' derivative suit. The Court of Appeals, however, reached the opposite conclusion. Its decision, we submit, has seriously undermined the primacy which has long been accorded to state law as the source of the legal rules applicable to the governance of corporations.

Business corporations—including mutual funds—are creatures of state, not federal, law. *Cohen* v. *Beneficial Loan Corp.*, 337 U.S. 541, 549 (1949).[8] While state statutes

[8] As this Court stated in *Cohen, supra:* "Whatever theory one may hold as to the nature of the corporate entity, it remains a wholly artificial creation whose internal relations between management and stockholders are dependent upon state law. . . ." *Id.* at 549. Mutual funds, though regulated under federal law, are still creatures of the states of their incorporation. *See* Lutz v. Boas, 39 Del. Ch. 585, 608, 171 A.2d 381, 395 (1961). While some commentators have suggested that this pattern be changed so that the federal government assumes the role of chartering corporations, *see, e.g.*, R. Nader, M. Green & J. Seligman, Constitutionalizing The Corporation: The Case for the Federal Chartering of Giant Corporations (1976) and Schwartz, *A Case For Federal Chartering of Corporations*, 31 Bus. Law. 1125 (1976), Congress has yet to enact such legislation.

vary somewhat with respect to the conduct of corporate affairs, directors are generally charged with the responsibility of managing or directing the management of business corporations.[9] This principle is fundamentally democratic: since directors are elected by vote of all of the shareholders for the very purpose of deciding where the corporation's best interests lie, the exercise of their business judgment concerning management of corporate affairs ordinarily binds all of the shareholders, even those who disagree with a particular directorial decision. Although each shareholder can refuse to vote for board members when they next stand for reelection if dissatisfied with the way they exercise their business judgment, the directors' judgment generally may not be questioned in the courts at the behest of a single shareholder. *Hawes* v. *Oakland*, 104 U.S. 450, 460-61 (1881); *Dimpfell* v. *Ohio & Mississippi R. Co.*, 110 U.S. 209, 210-11 (1884); 2 W. Fletcher, Cyclopedia of the Law of Private Corporations §§ 505, 528, 535 (1969 ed.).

This basic set of axioms reflects a legal and policy preference for the resolution of disputes concerning the management of corporations within the corporate structure, rather than in the courts. For the better part of a century, this Court has contributed significantly to the development and implementation of these principles, initially by setting forth the general rules reserving corporate management to duly elected, independent directors and carefully explaining the rationale upon which those rules are based, and more recently by rejecting suggestions advanced by dissentient shareholders that established state law concerning corporate governance should be subverted or ignored because of asserted conflicts with federal policies of one kind or another.

[9] *See, e.g.*, Delaware Code, Title 8, § 141(a) (1975); N.Y. Bus. Corp. Law § 701 (McKinney's Supp. 1977-78); ALI-ABA Model Bus. Corp. Act § 35 (rev. ed. 1974).

The business judgment rule evolved in this Court through a series of decisions stressing the directors' control over corporate assets, including the disposition of possible corporate claims. *See, e.g., Hawes, supra; Dimpfell, supra; Detroit* v. *Dean,* 106 U.S. 537 (1882).[10] In *Corbus* v. *Alaska Treadwell Gold Mining Co.,* 187 U.S. 455, 463 (1903), this Court stated:

> "The directors represent all the stockholders and are presumed to act honestly and according to their best judgment for the interests of all. Their judgment as to any matter lawfully confided to their discretion may not lightly be challenged by any stockholder or at his instance submitted for review to a court of equity. The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other considerations. It is not a trifling thing for a stockholder to attempt to coerce the directors of a corporation to an act which their judgment does not approve, or to substitute his judgment for theirs."

Fundamental—the corporation whose interests are the only ones at issue in this case—is a Delaware corporation, deriving such powers as it possesses under its Certificate of Incorporation and By-laws directly from Delaware law. Section 141(a) of the Delaware General Corporation Law provides in part that "[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors. . . ."[11] The Delaware courts have repeatedly held that a good faith exercise of business judgment by a corporation's board of directors—including a decision whether or not to sue on a possible corporate claim—may not be overturned by a shareholder through the mechanism of a derivative suit.[12]

[10] From the same cases, there emerged a procedural framework serving the same ends as the underlying substantive legal principles. *See* Ross v. Bernhard, 396 U.S. 531, 534 (1970). Because derivative suits may be inconsistent with the best interests of all shareholders and may in fact be abused, *see* Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 739-41 (1975), several significant procedural limitations have been imposed on derivative plaintiffs. One of the most important is the requirement that a dissentient shareholder exhaust intracorporate remedies. Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions,* 44 U. Chi. L. Rev. 168 (1976). The exhaustion requirement —which is a common feature of both the Federal Rules of Civil Procedure and of state practice—is implemented by imposing a duty upon a putative derivative plaintiff to make a demand on the directors to sue on his proposed claim, or to demonstrate specifically why such a demand would be futile. *See, e.g.,* Rule 23.1 of the Federal Rules of Civil Procedure; Delaware Chancery Court Rule 23.1.

If after such demand the directors conclude not to sue, their decision will be tested under the business judgment rule and will be final unless the shareholder can demonstrate that such decision was itself somehow tainted. As stated in *Stadin* v. *Union Electric Co.,* 309 F.2d 912, 921 (8th Cir. 1962) (Blackmun, C.J.), *cert. denied,* 373 U.S. 915 (1963): "'[T]he sine qua non of the stockholder's derivative right to sue' [after satisfying the demand requirement], is that management be guilty of conduct equivalent to bad faith or breach of trust." *See also* Comment, 44 U. Chi. L. Rev., *supra,* at 193-98; Detroit v. Dean, *supra*; McKee v. Rogers, 18 Del. Ch. 81, 156 A. 191 (1921). The likely impact of the Court of Appeals' decision in the instant case upon the exhaustion requirement is discussed in Point II, *infra.*

[11] Delaware Code, Title 8, § 141(a) (1975). The phrase "or under the direction of" was added to Section 141(a) in 1974, 59 Del. Laws, Ch. 437, § 25, for the sake of clarity and to make explicit results previously reached in the Delaware case law. 2 PH Corporations, Current Statutes 376 (1974).

[12] *See, e.g.,* McKee v. Rogers, *supra;* Ella M. Kelly & Wyndham, Inc. v. Bell, 266 A.2d 878 (Del. 1970); Moskowitz v. Bantrell, 41 Del. Ch. 177, 190 A.2d 749 (1963); Beard v. Elster, 39 Del. Ch. 153, 165, 160 A.2d 731, 738-39 (1960); Puma v. Marriott, 283 A.2d 693, 696 (Del. Ch. 1971). *See also* Davis v. Louisville Gas

Delaware law also provides flexible mechanisms that permit a board of directors to perform its functions when some directors are absent or may be disqualified by self-interest from exercising independent business judgment. Section 141(b) of the General Corporation Law provides for corporate decisions by majority vote of a quorum which may consist of less than a numerical majority of the whole board.[13] Indeed, under Section 144(a)(1), first enacted in 1967 and as amended in 1969, a majority of the independent directors of a Delaware corporation, whether or not they constitute a quorum, is specifically empowered to approve "transactions" between that corporation and its own directors or other corporations in which such directors have an interest.[14] Professor Folk, who served as the Reporter for the Delaware Corporation Law Revision Committee during 1964 through 1967, has stated that "transactions affected by § 144" should be broadly interpreted and should include, *inter alia*, "determinations with respect to maintaining suits by the corporation against persons allegedly injuring it. . . ." E.L. Folk, The Delaware General Corporation Law: A Commentary and Analysis 82 (1972).

& Electric Co., 16 Del. Ch. 157, 169, 142 A. 654, 659 (1928). This rule is one of general application under the law of most if not all jurisdictions. *See* Swanson v. Traer, 249 F.2d 854, 859 (7th Cir. 1957).

[13] Delaware Code, Title 8, § 141(b) (1975).

[14] The present version of Section 144 is set forth in the Addendum to this brief. The Section was originally enacted in 1967. 56 Del. Laws, Ch. 50. In 1968, the Delaware legislature made technical amendments to the Section, *see* 56 Del. Laws, Ch. 186, § 5, and in 1969, the Section was amended to its present form. 57 Del. Laws, Ch. 148.

Section 144(a)(1) is consistent with analogous principles of the Investment Company Act of 1940. *See, e.g.*, Sections 15(c) and 10(a) of the Investment Company Act of 1940, 15 U.S.C. §§ 80a-15(c) and 80a-10(a) (1970), which provide that adoption and renewal of the investment adviser's contract require a majority vote of the disinterested directors and that only 40% of the fund's directors need be disinterested.

In the present case, Fundamental's Certificate of Incorporation and By-laws provided, as was permissible under Section 141(a), that a quorum of one-third of the directors could transact business on behalf of the corporation. 404 F. Supp. at 1172, 1175 n.1. Thus, when the full board delegated to the independent quorum the question of whether pursuit of plaintiffs' proposed suit was in the best interests of Fundamental, under Section 141(a) that quorum became Fundamental's board with respect to deciding that question. Moreover, the delegation itself was a course of action expressly sanctioned by Section 144(a)(1). The subsequent decision of the independent quorum to seek dismissal was entitled to the deference normally accorded directors' decisions under the business judgment rule evolved at common law in Delaware and elsewhere.

This established state law framework, designed to promote informed decision-making within the corporate structure itself, was ignored by the decision of the court below, which permits two shareholders to substitute their judgment for that of the lawful quorum of Fundamental's directors determined by the District Court to be "truly disinterested and independent." 426 F. Supp. at 847. The Court of Appeals' decision requires a trial on the merits herein notwithstanding the independent directors' informed, good faith judgment that continuing with the case is not in the corporation's best interests.

The Court of Appeals erroneously believed that it was empowered to disregard state corporate governance law because the plaintiffs' claims were, at least in part, based on alleged violations of federal policies as set forth in the Investment Company Act. This holding disregards a long and remarkably uniform series of decisions by this Court that shareholders cannot wrest from the directors their authority, via the exercise of informed and independent business judgment, over potential corporate claims merely

because prosecution of those claims might arguably further certain federal interests.[15]

There are, of course, certain areas of substantive law where under the Supremacy Clause federal law preempts state law. The Court of Appeals evidently presumed that it was empowered to disregard state corporate law because a federal policy in favor of protecting mutual fund investors permitted such a result. However, the decision below sweeps far too broadly in simply ignoring the basic substantive state law governing the internal operations of corporations. We know of no decision that has reached a comparable result, no matter how "strong" a federal policy was involved.

The federal policy underlying the antitrust laws is so strong that the Sherman Act has been characterized as "the Magna Carta of free enterprise." *United States* v. *Topco Associates, Inc.*, 405 U.S. 596, 610 (1972). Yet even this fundamental federal policy does not displace the business judgment rule when a shareholder seeks to assert derivatively a corporate antitrust claim over directorial opposition. In *United Copper Securities Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917), this Court, relying on *Hawes, supra,* and its progeny, flatly rejected a shareholder's attempt to bring a treble damage action on behalf of a corporation after its directors had declined to file such a suit. In response to the same argument advanced by plaintiffs below—that federal policy would be thwarted unless the directors' business judgment was overridden—Justice Brandeis held:

> "The fact that the cause of action is based on the Sherman Law does not limit the discretion of the directors or the power of the body of stockholders; nor does it give to individual shareholders the right to interfere with the internal management of the corporation." 244 U.S. at 264.

[15] The Court of Appeals did acknowledge that, under Delaware law, the five independent directors constituted a lawful quorum of Fundamental's board, but it ignored both Section 144 and the controlling body of common law in passing upon the business judgment issue which was presented. *See* 567 F.2d at 1210 n.5.

In *Price* v. *Gurney,* 324 U.S. 100 (1945), corporate security holders filed a derivative bankruptcy petition alleging, as do the plaintiffs, that the directors of their company were guilty of a breach of trust and that the pervasive policy embodied in a federal statute (the Bankruptcy Act) permitted them to override the business judgment of the board of directors and invoke the jurisdiction of the bankruptcy court for the corporation's benefit without directorial consent. This argument was quickly rejected:

> "[N]owhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation. Respondents may have a meritorious case for relief. On that we intimate no opinion. But if they are to be allowed to put their corporation into bankruptcy, they must present credentials to the bankruptcy court showing their authority." 324 U.S. at 107.

The principle set forth in *United Copper* and *Price* has been consistently followed by this Court, albeit in somewhat different contexts. *See Cort* v. *Ash,* 422 U.S. 66 (1975).[16] Indeed, even in the area of federal regulation

[16] In *Cort,* this Court was faced with a shareholder derivative claim for damages based upon as intrinsic a federal concern as the integrity of federal elections under the Federal Election Campaign Act. There, as here, the shareholder, complaining of supposed federal statutory violations, asserted the right to maintain his damage action to recover allegedly unlawful campaign

of transactions in securities this Court has refused to allow interference with state laws of corporate governance. In *Santa Fe Industries, Inc.* v. *Green,* 430 U.S. 462 (1977), this Court refused to allow a shareholder to maintain a derivative action raising federal securities antifraud claims under the Securities Exchange Act of 1934 (analogous to those raised by plaintiffs here) on behalf of a corporation involved in a Delaware statutory short-form merger. Reiterating its earlier holding in *Cort* v. *Ash, supra,* this Court held in *Santa Fe* that the transaction at issue did not give rise to a cause of action under Section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder, in part because to do so would "overlap and quite possibly interfere with state corporate law." 430 U.S. at 479. Noting that the several states had adopted differing statutory standards governing short-form mergers, *id.* at n.16, this Court stated:

> "Absent a clear indication of congressional intent, we are reluctant to federalize the substantial portion of the law of corporations that deals with transactions in securities, particularly where established state policies of corporate regulation would be overridden." *Id.*

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contributions for the corporation's benefit. Mr. Justice Brennan, writing for a unanimous court, refused to imply a federal cause of action under that statute, stating that "[A private cause of action by a stockholder to secure derivative damage relief] is available, if at all, under Delaware law governing corporations." 422 U.S. at 77-78 (footnote omitted). This decision was based, in part, on the ground that:

> "Corporations are creatures of state law, and investors commit their funds to corporate directors on the understanding that, except where federal law expressly requires certain responsibilities of directors with respect to stockholders, state law will govern the internal affairs of the corporation. . . . We are necessarily reluctant to imply a federal right to recover funds used in violation of a federal statute where the laws governing the corporation may put a shareholder on notice that there may be no such recovery." *Id.* at 84-85.

See also St. Louis Union Trust Co. v. *Merrill Lynch, Pierce, Fenner & Smith,* 562 F.2d 1040, 1052 (8th Cir. 1977), *cert. denied,* 98 S.Ct. 1490 (1978) (rejecting an attempt to read a requirement into Rule 10b-5 that would have the effect of overriding provisions of the Delaware General Corporation Law governing stock transfer restrictions).

This Court has thus consistently deferred to state law relating to the management of business corporations, including the elemental principle of state law that independent and disinterested corporate directors have the responsibility and obligation to determine the course of action which is in the corporation's best interests. The business judgment rule and the Delaware statutes providing for management of Fundamental by a disinterested quorum of directors defeat attempts by shareholders to sue over the directors' objection, even though the proposed derivative claim is grounded in part on a federal statute.

The court below nevertheless concluded that "the plethora of cases . . . dealing with the powers of boards of directors to terminate stockholder derivative suits and the effect of the demand requirement under Fed. R. Civ. P. 23.1 are inapposite." 567 F.2d at 1212 n.14. It offered two reasons for its decision to disregard these authorities. The first was an irrebuttable legal presumption, based largely upon subjective psychological factors, that the independent directors were here disqualified from exercising their business judgment because they could not pass fairly on a claim directed in part at some of their fellow directors. Since the independent directors "must constantly deal with interested directors in a spirit of accommodation," since they must "rely on the information and expert advice provided by the adviser and the majority directors," and since their continued service and receipt of directors' fees depend "almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection," the court below stated that:

> "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." *Id.* at 1212.

The second reason offered was "the unique nature of the investment company and its symbiotic relationship with its investment adviser," *id.* at 1212 n.14, which the Court of Appeals discerned from a selection of previous mutual fund decisions and the federal statutory framework regulating certain mutual fund activities.

Neither reason provides sufficient basis for a decision incompatible with this Court's prior decisions in *United Copper, Price, Cort,* and *Santa Fe,* which require compliance with state law concerning corporate governance, and, as we show below, neither reason is persuasive as a matter of law, policy, or logic.

II.

The Decision of the Court of Appeals That the Independent Quorum Was Presumptively Disqualified From Exercising Its Business Judgment Threatens To Expand Greatly Shareholder Derivative Litigation in the Federal Courts

The irrebuttable legal presumption created by the Court of Appeals to support its conclusion that the independent quorum herein lacked the power to decide to seek dismissal of plaintiffs' derivative suit was one of two bases upon which that court concluded that previous decisions upholding the authority of independent directors to control corporate litigation were "inapposite" to decision of this case.[17]

That presumption has consequences extending beyond this case, and it should be rejected by this Court. In this portion of our brief, we show that: (A) the Court of Appeals' presumption is precisely contrary to the central premise underlying the recent tendency of our legal system to place significant numbers of "outside" or independent directors on the boards of all types of corporations, a trend which has employed the mutual fund industry as a model; (B) the presumption improperly reverses the traditional preference, reflected in both the business judgment rule and Rule 23.1 of the Federal Rules of Civil Procedure, for resolution of disputes concerning corporate management within the structure of the corporation rather than in the

[17] There is no doubt that the Court of Appeals held, as a matter of law, that the independent quorum was without power to act. Although the court below set out several bases for its presumption as to "human nature," it clearly did not believe that an independent quorum of board members—even one constituting over 40% of the full board—could ever pass fairly upon proposed corporate claims directed in part at fellow directors. The Court of Appeals expressly stated that it was "unnecessary to consider the findings of the district court that the disinterested directors were sufficiently independent," and that it had no doubt that "the five minority directors acted in good faith in all that they did." 567 F.2d at 1212.

courts; (C) the factors relied upon by the Court of Appeals in support of its presumption do not, in fact, dictate such a result; and (D) the Court of Appeals' "frivolous case" exception to its presumption will also lead to increased derivative litigation, a result which is unnecessary since the District Court's approach herein is not only consistent with the purpose of both the business judgment rule and Rule 23.1, but also avoids any unfairness to shareholders.

Thus, unless this Court acts to remove the impediment which the Court of Appeals created to the ability of an independent quorum to make good faith, informed decisions that bind dissentient shareholders, the effect will be to expand shareholder derivative litigation involving mutual funds and, perhaps, all business corporations.

A. The Court of Appeals' Presumption Is Inconsistent With the Recent Trend To Add Significant Numbers of Outside Directors to Corporate Boards and To Rely More Heavily on Them

In the recent past, a great deal of attention has been focused on the performance of corporate boards of directors. One suggestion that has emerged from this debate has been the notion, referred to above, that the federal government should take over the states' function of chartering major corporations. Another, more measured response has been an increasing emphasis upon more carefully defining the proper function of the board of directors and, at the same time, strengthening the capabilities of directors to perform that function. *See* ABA, Corporate Director's Guidebook (rev. ed. Jan. 1978), reprinted in 33 Bus. Law. 1595 (1978).

Coincident with this effort, numerous commentators who have studied corporate governance have recommended that corporations add outside directors to their boards, and that the operational structure of boards be modified so that all of the directors can better assist in sound management of the firms whose shareholders they serve. This

has been more than an academic exercise, for many American corporations have responded by placing significant numbers of independent directors—*i.e.*, directors who are not corporate officers or employees—on their boards.[18] As this has occurred, students of corporate governance have identified the "monitoring function of outside directors" as "the central role of the board of the future" and have pointed out that a model for a board with substantial numbers of independent directors performing such a function already exists in the mutual fund industry. Leech & Mundheim, *The Outside Director of the Publicly Held Corporation*, 31 Bus. Law. 1799, 1804, 1806 (1976). *See also* Address by S.E.C. Commissioner Roberta Karmel, American Society of Corporate Secretaries, Jan. 11, 1978.

Indeed, this trend is regarded as so significant that, in a number of non-mutual fund contexts, independent directors have been required to be added to corporate boards to perform a "watchdog" role. For example, the New York Stock Exchange recently issued a requirement that each company listed on the exchange have an Audit Committee composed of outside directors, *see* Cohen, *The Outside Director—Selection, Responsibilities, and Contribution to the Public*

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[18] This trend has been summarized as follows:

"The Conference Board's Jeremy Bacon confirms that his research over the years has shown a steady increase in the number of manufacturing companies having a majority of outside directors [—those who are not salaried employees of the corporation and who are not involved in day-to-day staff or operating decisions—] on their boards. In 1967 this figure was 63% of the companies studied; in 1973, 71%. The 1976 figure reflects that 83% of the nearly 300 companies studied had an outside majority.

"A separate analysis of 175 leading corporations (made by my own office) showed 86% with a majority of outsiders, 10% with a minority, and the 4% balance having equal representation of outsiders and insiders. Both my study and that of the Conference Board confirm that the number of outside directors tends to rise with the size of the company, its complexity, and the extent of its international involvements." Estes, *The Emerging Solution to Corporate Governance*, 55 Harv. Bus. Rev. 20, 21-22 (Nov.-Dec. 1977).

Corporation, 34 Wash. & Lee L. Rev. 837 (1977), and the Securities and Exchange Commission has often required the addition of independent directors when entering into consent decrees with corporations that have been the targets of S.E.C. enforcement actions. *Id.* at 847 and n. 25.

The Court of Appeals, by relying upon vague notions of "human nature" presumptively to disqualify the independent quorum from exercising its business judgment in this case, has intruded upon these developments. By holding that, as a matter of law, the independent quorum lacked the power to make an admittedly difficult decision, the court below in effect entered a sweeping condemnation of the trend described above. Although its action in this regard was probably unintentional, the court's timing could not have been more unfortunate.

It is, in our view, wrong to substitute such a presumption for the careful factual analysis of the quorum's independence and good faith here conducted by the District Court. But beyond that error, the Court of Appeals' approach amounts to a legislative conclusion that the addition of independent directors to mutual fund boards, and by logical extension to corporate boards generally, is merely a symbolic gesture since, "human nature" being what it is, such directors will never be able to divorce their judgment from that of management on matters confided to their discretion. If Congress or the state legislatures are to reach such a judgment in the future, they will presumably do so after examining in detail the performance over time of the independent directors who are only now beginning to serve in significant numbers on corporate boards. Yet the court below has prejudged that issue, ignoring detailed factual findings on the precise question of independence and accepting that the quorum here acted in good faith.

Thus, unless reversed the decision below threatens to stifle the many forces—legal, political and social—which

are combining to change substantially the structure, function, and composition of corporate boards so as to increase the responsibilities and abilities of independent directors to perform a monitoring function.[19] To the extent that this occurs, the courts will inevitably be burdened with more derivative litigation. The results will be both direct, since under the Court of Appeals' reasoning the independent directors had no authority to resolve within the corporation's structure an issue like that presented here, and indirect, since the court's conclusion may actually retard the realization in practice of a model board structure which depends upon service by a significant percentage of independent directors.

B. The Court of Appeals' Presumption Improperly Permits Putative Shareholder Derivative Plaintiffs To Avoid Intracorporate Resolution of Disputes

As we have shown, the business judgment rule rests on a clear policy preference for intracorporate decision-making by the directors charged by state law with managing the affairs of the company. Rule 23.1 of the Federal Rules of

[19] Much of the current literature discussing changes in the structure and functions of corporate boards is summarized in Leech & Mundheim, *supra,* and in an introduction to rules which the S.E.C. has recently proposed which would require corporations to disclose more information about the affiliations of board members with the corporation and with management. *See* 43 Fed. Reg. 31,945 (July 24, 1978). Leech and Mundheim point out that the "monitoring role for independent, outside directors of business corporations, modeled on mutual fund requirements, would in fact be beneficial not only to the shareholders of the corporation, but to management as well." Leech & Mundheim, *supra,* 31 Bus. Law. at 1805. In support of this observation, they cite the District Court's decision in the instant case and *Puma* v. *Marriott, supra,* a Delaware case in which the court refused to reexamine a transaction involving possible conflict between the corporation and insiders, stating that "[s]ince the transaction . . . was accomplished as a result of the exercise of independent business judgment of the outside, independent directors whose sole interest was the furtherance of the corporate enterprise, the court is precluded from substituting its uninformed opinion for that of the experienced, independent board members. . . ." 283 A.2d at 696.

Civil Procedure[20] is based on the same rationale.[21] When strictly enforced by the courts, that Rule—which requires a putative derivative plaintiff to provide particularized allegations of the efforts, if any, which he or she made to obtain the desired action from the directors and the reasons for failure to obtain such action or not making such an effort—has the effect of requiring disputes relating to corporate management to be resolved by the directors.[22] Accordingly, cases decided under Rule 23.1 are relevant to the decision in this case, although the court below—because of its rule of presumptive disqualification—chose to ignore such decisions.

The courts have held that the pleading requirement of Rule 23.1 "represents a deliberate departure from the relaxed policy of 'notice' pleading promoted elsewhere in the Federal Rules," *Heit* v. *Baird, supra*, 567 F.2d at 1160, and that the Rule "places an initial burden on the stockholder 'to demonstrate why the directors are incapable of doing their duty,' and failure to meet this burden requires dismissal of the suit." *Id.* (citation omitted). *See also Kauffman, supra*, 479 F.2d at 263. This Court has stated that demand will be excused only upon a showing of "extraordinary conditions," *Ross* v. *Bernhard, supra*, 396 U.S. at 534, and many courts have been exceedingly skeptical about accepting conclusory allegations, such as those employed by plaintiffs in their complaint in this case, *see* A. 50-51, as sufficient to explain why a demand on the directors would be futile.[23] Moreover, dismissal motions grounded upon Rule 23.1 have been successful in instances where: (1) a majority of the board of a corporation was not shown to be disabled from passing on the questions presented[24]; or (2) the composition of the board had changed significantly between the time either when the cause of action arose, when a previous demand was rejected, or when a complaint was filed, and the time of moving for dismissal.[25]

[20] Rule 23.1, Fed. R. Civ. Proc., entitled "Derivative Actions by Shareholders," provides, in pertinent part:

> "In a derivative action brought by one or more shareholders . . . to enforce a right of a corporation . . . the corporation . . . having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege . . . with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors . . . and, if necessary, from the shareholders . . . and the reasons for his failure to obtain the action or for not making the effort. . . ."

[21] *See, e.g.*, In re Kauffman Mutual Fund Actions, 479 F.2d 257, 263 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973); Meyers v. Keeler, 414 F. Supp. 935, 938 (W.D. Okla. 1976); 3B J. Moore, *supra*, ¶ 23.1.15[4]; 7A C. Wright & A. Miller, Federal Practice and Procedure: Civil § 1832 (1972 ed.); Comment, 44 U.Chi.L.Rev., *supra*, at 171; Note, *Demand on Directors and Shareholders as a Prerequisite To A Derivative Suit*, 73 Harv.L.Rev. 746, 759 (1960).

[22] Professor Moore has observed that "[t]here is no unanimity of opinion among the courts, and probably the most straightforward approach is to admit frankly that it lies within the sound discretion of the court to determine the necessity for a demand." 3B J. Moore, Federal Practice, ¶ 23.1.19, at p. 23.1-83 (2d ed. 1978). *Compare*, Kauffman, *supra*, and Heit v. Baird, 567 F.2d 1157 (1st Cir. 1977) *with* deHaas v. Empire Petroleum Co., 286 F. Supp. 809 (D. Colo. 1968), *aff'd in part and vacated in part*, 435 F.2d 1223, 1228 (10th Cir. 1970) ("[c]ourts have generally been lenient in excusing demand") *and* Liboff v. Wolfson, 437 F.2d 121, 122 (5th Cir. 1971).

[23] The allegation that Fundamental's board "failed to take action" is squarely contradicted by the board's institution of an action against Goldman, Sachs in late 1970 and its settlement for a substantial sum in 1974. *See* p. 5, *supra*. The other conclusory allegations could certainly be attacked on Rule 23.1 grounds as well. *See, e.g.*, Meyers v. Keeler, *supra*, 414 F. Supp. at 938; Brooks v. American Export Indus., Inc., 68 F.R.D. 506, 510 (S.D.N.Y. 1975) (fact that all directors named as defendants does not, in itself, excuse demand); Baffino v. Bradford, 57 F.R.D. 79 (D.Minn. 1972).

[24] *Kauffman, supra*, 479 F.2d at 264; *Heit, supra*, 567 F.2d at 1161; Abrams v. Mayflower Investors, Inc., 62 F.R.D. 361, 368-70 (N.D. Ill. 1974); Lerman v. ITB Management Corporation, 58 F.R.D. 153, 156-59 (D. Mass. 1973).

[25] Brody v. Chemical Bank, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973), *on remand*, 66 F.R.D. 87, 89 (S.D.N.Y. 1974), *aff'd*, 517 F.2d 932, 934 (2d Cir. 1975); Independent Investor Protective League v. Saunders, 64 F.R.D. 564, 571 (E.D. Pa. 1974). *See also* Corey v. Independent Ice Co.,

All of this authority suggests that the court below reached the wrong result in stripping the independent quorum of the power to decide whether pursuit of plaintiffs' proposed claims was in the best interests of all of Fundamental's shareholders. The demand rule serves to assure that the directors of a corporation will have the opportunity to make such business judgments, and it is simply not consistent with the letter and spirit of that rule to presume that the directors will not fairly discharge their obligations in this regard. Indeed, in cases such as *Hawes, Dimpfell,* and *Corbus, supra,* this Court has made it clear that a board decision not to pursue a corporate claim after a demand is made will not be overturned unless the putative derivative plaintiff demonstrates that such decision was itself tainted by fraud, corruption, or gross bad faith—none of which are even arguably present here.

The Court of Appeals' presumption, of course, contradicts the results reached in these cases. Thus, it will simply breed confusion as to when a demand is or is not required. Moreover, future derivative plaintiffs will, we submit, draw upon the decision below in an effort to avoid altogether the demand requirement of Rule 23.1. Derivative plaintiffs have commonly employed the language of decisions discuss-

207 F. 459, 464 (D. Mass. 1913) (complaint alleging demand on directors nineteen months before filing suit should also allege that the same directors were presently in office to comply with the demand requirement); 7A C. Wright and A. Miller, Federal Practice and Procedure: Civil § 1831, at 377-78 (1972 ed.) ("if a substantial period has transpired between the demand and institution of the action, the court may insist on a second demand or proof that the directors or the nature of the claim have not changed"); 3B Moore's Federal Practice, *supra* ¶ 23.1.19, at 23.1-81-82 (1978 ed.) ("[F]rom the particular facts alleged, it must appear that a new board of directors has not been installed. . . . [A] shareholder's suit is to be resorted to as a last alternative, and . . . the corporation is given every possibility to sue in its own name").

In the present case, of course, the composition of Fundamental's board did change between the time the complaint was filed and the time the motion to dismiss was filed. That change occurred by means of the delegation of authority to the independent quorum.

ing the power of corporate directors to render binding business judgments in drafting their pleadings alleging that demand would be futile. At least in this sense, the language which the court below used to set forth and to support its presumption will—if this Court approves the result below—appear repeatedly in innumerable future derivative complaints explaining why demand on the board of directors should be excused. And, because of the way the court's presumption was expressed, this effect is likely to be quite severe.

There is nothing in the presumption, or in the assumption as to "human nature" upon which it is based, that confines its application to corporations which happen to be mutual funds. Thus, the presumption—if applied in future cases to publicly-held corporations generally—would make pointless asking the independent directors to decide whether to pursue a proposed corporate claim against another director. Moreover, given the presumption, there is no logical distinction between the facts presented here and situations where a board majority (*e.g.,* 60%) is independent; as long as some board members were allegedly involved in the acts complained of, those who were not involved would be under the same presumptive disability to pass fairly on the wisdom of the claims.[26] Rule 23.1 and the policies which it embodies have thus been emasculated, since there is little purpose in requiring a demand on independent directors who are disqualified as a matter of law from exercising their business judgment concerning the corporation's best interests.

[26] In such situations, paraphrasing the opinion below, the independent members of a board, albeit a majority, still "must constantly deal with [their management colleagues] in a spirit of accommodation," still "are compelled for the most part to rely on the information and expert advice provided by [the management] directors," and still receive compensation during their service on the board which "depends almost entirely on the establishment of satisfactory working arrangements between them and the [management directors] responsible for their selection." 567 F.2d at 1212.

Indeed, plaintiffs in shareholder derivative suits have already begun citing the opinion of the court below as a basis for opposing dismissal motions based on Rule 23.1. In *Untermeyer* v. *Fidelity Daily Income Trust*, 79 F.R.D. 36 (D. Mass), *rev'd*, 580 F.2d 22 (1st Cir. 1978), such a claim was rejected in the District Court on the strength of *Kauffman* and *Heit, supra*. The District Judge noted that, because the opinion below "does not address the requirement of demand on the board of directors, and comments that Rule 23.1 cases are inapposite," 79 F.R.D. at 46 n. 29, it is not strictly inconsistent with those earlier decisions of the First Circuit. The District Court, however, went on expressly to reject the presumption employed below: "To the extent that *Lasker* assumes the independent directors to be captive to the will of the interested directors, this court disagrees." *Id.*[27]

Further, in at least one case, *Auerbach* v. *Bennett*, 64 A.D.2d 98, 408 N.Y.S.2d 83 (2d Dept. 1978), the decision below was the principal support for reversal of a grant of summary judgment dismissing a derivative suit filed by a shareholder of an ordinary business corporation. Although the corporation's board, in the exercise of its business judgment, had decided to seek dismissal of the case, the state court held that discovery should proceed. In response to the corporation's argument that the Court of Appeals' decision in the instant case should be confined to cases involving mutual funds, the *Auerbach* court stated that: "We do not perceive that the fiduciary duties of the directors of a business corporation differ substantially

[27] We question the *Untermeyer* District Court's attempt to distinguish the opinion below. In our view, application of the presumption to facts such as those in *Kauffman* and *Heit, supra*, where complaints were held deficient because they did not show that majorities of the boards were disabled from exercising their business judgment, might well call for different results in those cases.

The decision of the First Circuit reversing the District Court does not discuss the presumption *per se*.

from the duties of directors of a mutual fund." 64 A.D.2d at 108 n. 6, 408 N.Y.S.2d at 88 n. 6.

The thrust of plaintiffs' argument throughout this case has been that many of the business judgment decisions discussed herein are inapplicable because they were cases in which a board of directors, after receiving a demand, chose not to pursue a cause of action proposed by a shareholder, or in which the shareholder-plaintiff unsuccessfully contended that demand was excused. Since Fundamental did not attack the complaint on Rule 23.1 grounds, plaintiffs characterize this case as a "validly commenced derivative action which has proceeded beyond the threshold issue of demand," and contend that the board no longer has a role to play with respect to it. Plaintiffs' Brief in Opposition to the Petition herein at 5.

That argument begs the question. If such an argument were accepted, it would follow that the *only* opportunity that the independent members of a corporate board have to pass on whether a proposed cause of action is in the corporation's best interests is if the putative plaintiffs and their counsel are so careless as to make a demand of the board before filing suit—a step which the presumption itself makes it easier to avoid. The demand rule itself confers no such talismanic immunity upon a derivative plaintiff, and the rationale upon which it is based argues for a continuing role for the board with respect to the conduct of derivative litigation. The powers of the board in such circumstances are determined by reference to state law, not by reference to an unsupported presumption as to "human nature." *See also* note 25, *supra*, and accompanying text.

It is unnecessary and indeed unwise to risk these consequences by affirming the Court of Appeals' decision. The District Court's approach in this case, as we urge above, has a far stronger basis in law, policy and logic, for it preserves the right of truly independent directors generally, and independent directors of mutual funds in particular, to resolve the question whether a claim should be

pursued, while permitting judicial evaluation of the limited issue of the directors' independence. "If a stockholder could compel the officers [of a corporation] to enforce every legal right, courts, instead of chosen officers, would be the arbiters of the corporation's fate." *Ashwander* v. *Tennessee Valley Authority,* 297 U.S. 288, 343 (1936) (Brandeis, J., concurring). By strengthening the hand of derivative plaintiffs in mutual fund litigation—and, by logical extension, in corporate litigation generally—the court below has necessarily expressed a preference for judicial resolution of such intracorporate disputes. That result—and the concomitant increase in complex federal court litigation—should be based on firmer footing than the vague presumption relied upon below.[28]

[28] As we have suggested in Point I, *supra,* the Court of Appeals' presumption is directly contrary to the legislative presumption underlying Section 144(a)(1) of the Delaware General Corporation Law which permits independent directors to approve transactions which may serve to benefit one or more of their colleagues on the board. Moreover, it conflicts with the general common law presumption that directors act honestly and in good faith to decide issues committed to their discretion. *See* Corbus, *supra,* 187 U.S. at 463; Robinson v. Pittsburgh Oil Ref. Corp., 14 Del. Ch. 193, 199, 126 A. 46, 48 (1924). Finally, as suggested in Point III, *infra,* the presumption conflicts with that drawn by Congress in stressing the role of independent directors in the Investment Company Act of 1940 and the amendments thereto.

Quite aside from these considerations, this Court has often condemned the use of blanket presumptions as a substitute for more searching inquiry. In *Vlandis v. Kline,* 412 U.S. 441, 446 (1973), this Court stated that such presumptions "have long been disfavored under the Due Process Clauses of the Fifth and Fourteenth Amendments." The principal reason is the unfairness of employing a "permanent and irrebuttable presumption . . . [which] is not necessarily or universally true in fact" where there are "reasonable alternative means of making the crucial determination." *Id.* at 452. *See also* Cleveland Bd. of Education v. La Fleur, 414 U.S. 632, 644-45 (1974). While we are of course not urging a constitutional claim in this case, the principles underlying this Court's skepticism about irrebuttable presumptions serve equally well here. As we show in Point II C and D below, the Court of Appeals' presumption seems to us to lack factual and logical bases and the District Court's inquiry into the deciding directors' *bona fides* provided a "reasonable alternative means of making the crucial determination." 412 U.S. at 452.

C. The Presumption Has No Factual or Logical Basis

Although we believe the result reached by the Court of Appeals is unwise, it might be tolerable if the factors upon which that court based its presumption could be said to promote fairness or provide significant protection to investors. Accordingly, we turn to a brief analysis of the three factors relied upon below.

First, the court observed that the directors who constituted the independent quorum had an ongoing relationship with their fellow directors and "must constantly deal with interested directors in a spirit of accommodation." 567 F.2d at 1212. This is a curious basis upon which to presume that the independent quorum should be stripped of responsibility for deciding whether pursuit of a lawsuit directed in part at the other directors serves the best interests of all the shareholders. The reasoning is, at best, circular. The current policy emphasis on increasing the number of independent directors serving on corporate boards is based in significant part on the theory that by developing such working relationships with the "inside" or "management" directors, the independent directors will best be able to fulfill their function of assisting in the sound management of the firm. The Business Roundtable recently issued a statement endorsing the increasing prevalence of outside directors. In discussing the appropriate relationship between the board (including, of course, its outside directors) and the chief executive officer (the quintessential inside director), that statement observed:

> "First, the relation between board and the chief executive officer should be challenging yet supportive and positive. It should be arm's length but not adversary. The board should stimulate management to perform at the peak of its capacity not by carping, but by setting high standards and providing level-headed encouragement. Communication, collaboration and mutual confidence should be objectives.

"Second, the atmosphere in the board room ought to be one of free and open discussion. This is the case now in many corporations. Strong, independent directors, well informed on the problems to be discussed, openly debate the pros and cons of questions presented. The atmosphere, set principally by the board chairman, encourages—rather than discourages—debate on the advantages of alternative courses of action. The information system provides a factual basis for that discussion. Searching questions are welcomed. The strong chief executive officer seeks the best judgment of his independent, strong, informed directors to maximize the soundness of board decisions." Statement of the Business Roundtable, *The Role and Composition of the Board of Directors of the Large Publicly Owned Corporation,* 33 Bus. Law. 2083, 2110-11 (1978).[29]

We submit that it is manifestly inconsistent to encourage, on the one hand, the addition of independent directors to corporate boards and the development of close working relationships between such directors and their management-related brethren, and to employ, on the other, the existence of such relationships as a basis upon which to presume that the independent directors lack the strength of character to make hard choices when necessary.

A second basis for the court's presumption was its observation that the independent directors had to "rely on the

[29] *See also* Leech & Mundheim, *supra:*

"The identification of monitoring as the central role for outside directors does not detract from the value of the board or of individual members as advisers or consultants to management or as the avenue for obtaining resources or information that would be useful to the corporation. Moreover, . . . outside directors share with their insider counterparts on the board the responsibility for setting the goals of the corporation. An ideal group of outside directors would provide these services to the corporation while at the same time performing the vital monitoring function." 31 Bus. Law. at 1806.

information and expert advice provided by the adviser and the majority directors" during their service on the board. 567 F.2d at 1212. This factor is obviously related to the first, and is subject to the same criticism. Moreover, in both the mutual fund and general corporate contexts, the law is clear that the other members of the board and corporate management are under a legal duty to provide the members of the independent quorum and their counsel with complete and accurate information upon which to base a decision committed to their judgment. *See, e.g., Moses* v. *Burgin,* 445 F.2d 369, 376 (1st Cir.), *cert. denied,* 404 U.S. 994 (1971); *Fogel* v. *Chestnutt, supra,* 533 F.2d at 745; *Tannenbaum* v. *Zeller,* 552 F.2d 402, 417 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977); Del. Code, tit. 8, § 144 (a)(1) (1975). If there had been a breach of this duty, the independent quorum's determination would not be entitled to the deference accorded under the business judgment rule, but there was no such breach in this case.

The final factor which the court below cited in support of its presumption was that the independent quorum's continued receipt of directors' compensation, ranging here "from $11,000 to $13,000 *per annum,* depends almost entirely on the establishment of satisfactory working arrangements between them and the majority responsible for their selection." 567 F.2d at 1212.[30] This factor is also mired in circular reasoning, for it is generally urged that independent directors must be well compensated in order both to encourage strong, competent individuals to accept

[30] According to the record, the maximum annual compensation of the independent directors ranged from $11,025 to $12,500. (R. 233A-240A). This compensation was, however, attributable to service on the boards of more than one of the Anchor group of funds, not solely on service on Fundamental's board. With respect to the selection of directors, the record shows that all members of the independent quorum who acted in this case were suggested for nomination by a Director's Qualification Committee of which, at all times, a majority (two out of three members) consisted of statutorily disinterested directors under the Investment Company Act. (A. 143, 163; R. 195A).

such directorships in the first place, and to assure that such directors, once on the board, will spend the considerable time necessary to fulfill properly their obligations to the shareholders. *See* Leech & Mundheim, *supra*, 31 Bus. Law at 1831-1833; Cohen, *supra*, 34 Wash. & Lee L. Rev. at 849; D.S. Ruder, Report on Symposium Held at Harvard Business School: The Role and Composition of the Board of Directors of a Large Publicly Held Corporation at 7 (May 25, 1977). Moreover, the compensation paid directors in this case is hardly exorbitant. A recent survey of directors' compensation shows that the median annual compensation level for outside directors of financial companies was $6,300 per annum, while in other non-manufacturing and manufacturing concerns the levels were $7,000 and $9,300 per annum. Further, in larger companies with over $3 billion in assets (or the equivalent in sales), the survey revealed median annual compensation levels for financial companies, non-manufacturing companies and manufacturing companies of $12,000, $15,500 and $17,500, respectively. The Conference Board, *Corporate Directorship Practices: Compensation 1977* at viii (1978). Finally, other courts have rejected similar claims as a basis for questioning the exercise of directorial judgment.[31]

In sum, the factors underpinning the Court of Appeals' presumption do not support the drastic result reached

[31] In *Warshaw* v. *Calhoun*, 43 Del. Ch. 148, 158, 221 A.2d 487, 493 (1966), for example, the court stated:

> "We think the mere statement of fact of salary payments . . . to some of the [defendant company] directors does not, in itself, overcome the presumption of good faith accorded to the acts of directors."

And in *Reserve Management Corp.* v. *Anchor Daily Income Fund*, [1978] Fed. Sec. L. Rep. (CCH) ¶96,566 at 94374 n.12 (S.D.N.Y. 1978), the court rejected such an argument directed at the same independent directors whose judgment is questioned in this case, stating: "To get persons of solid business judgment to serve [as independent directors] without some compensation would be impractical and is more than Congress required. Moreover, persons of such standing would not ordinarily sell their souls for a pittance. . . ."

here. Indeed, the present chairman of the Securities and Exchange Commission, Harold M. Williams, a vigorous proponent of independent boards of directors, recently expressed a view wholly at odds with the notion that a legal presumption is the appropriate way to judge the ability of independent directors fairly to decide issues. Arguing in favor of recent S.E.C. proposals to require increased disclosure concerning the affiliations of actual and prospective board members with corporate management,[32] Chairman Williams stated:

> "I agree that an individual's merit as a director turns more on intangibles than on conformity with objective criteria aimed at measuring independence. While the capability of rendering independent judgment is, in the final analysis, a qualitative matter which cannot definitively be described in proxy material, the nature and extent of a director's relationship with the company and its management certainly bear upon both the fact and the appearance of independence." Letter to the Editor, Harold M. Williams, The Wall Street Journal, November 2, 1978, at 22, col. 4.

We submit that the District Court, which eschewed reliance on "objective criteria" in favor of findings of fact based on a review of the "qualitative" evidence concerning the independence and good faith of the deciding directors in this case, struck the proper balance between fairness to all of Fundamental's shareholders and the authority of its board to guard their interests.

D. The Court of Appeals' "Frivolous Case" Exception to Its Rule of Presumptive Disqualification Is Not an Adequate Substitute For the District Court's Careful Factual Inquiry Concerning the Independent Quorum's Decision

In the instant case, the court below sought to ameliorate the harshness of its new rule of presumptive

[32] The proposed S.E.C. rules concerning such disclosures are set forth in 43 Fed. Reg. 31,945 (July 24, 1978).

disqualification by suggesting that it should only apply to "non-frivolous" actions. 567 F.2d at 1212. Although not specifically defined, the court apparently regarded "non-frivolous" cases as those in which it could not "say that, following a trial on the merits, the defendants would be found free from liability." *Id.* at 1210.

Because the court thought that at least one of the plaintiffs' claims might possibly succeed after trial, it was willing to presume that the independent quorum lacked the capacity to weigh the benefits of pursuing those claims against the disadvantages which such a course of action would entail. Thus, even the court's attempt to limit the reach of the presumption serves to increase the potential for excessive derivative litigation created by the decision below, for it ignores the numerous business factors—unrelated to the legal merits of a proposed suit—which this and other courts have frequently recognized as appropriate to a prudent decision as to whether or not a corporate claim should be pursued.[33] In our view, the pertinent case law counsels an approach such as that employed by the District Court. By elevating evaluation of the legal merits of the proposed derivative claim to a pre-eminent position in any analysis of an exercise of business judgment by corporate directors, the court below once again significantly undercut the very purpose of the business judgment rule.

Several cases decided subsequent to the Court of Appeals' opinion herein have refused to follow the approach of the court below, preferring instead an inquiry such as

[33] *See, e.g., Corbus, supra,* 187 U.S. at 463; Bernstein v. Mediobanca di Credito, 69 F.R.D. 592, 597 (S.D.N.Y. 1974); Puma v. Marriott, *supra;* Findley v. Garrett, 109 Cal.App.2d 166, 174, 240 P.2d 421, 426 (1952); Goodwin v. Castleton, 19 Wash.2d 748, 764, 144 P.2d 725, 733 (1944). *See also* note 12, *supra.* This result also conflicts with the Second Circuit's own prior precedent in *Fogel* v. *Chestnutt, supra,* where a different panel of that court stated that the performance of statutory duties by mutual fund independent directors required them to evaluate both "legal difficulties" and "economic pros and cons." 533 F.2d at 749-50.

that conducted by Judge Werker. In *Cramer* v. *General Telephone & Electronics Corp.,* 582 F.2d 259 (3d Cir. 1978), a derivative suit was filed seeking recovery from some directors and the auditors of GTE, a business corporation, of allegedly improper payments made to foreign governmental officials and private parties. About two months before Cramer's complaint was filed, GTE's board formed a Special Litigation Committee composed of independent directors to determine whether or not to pursue two other derivative suits that had been filed immediately after the improper payments had been disclosed. The Committee, relying on advice from independent counsel, determined that prosecuting the actions was not in GTE's best interests, and the board ultimately decided to seek dismissal of all three derivative suits. In *Cramer,* the Court of Appeals for the Third Circuit affirmed dismissal of plaintiff's claims under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder on the ground of failure to make demand as required by Rule 23.1. Although the District Court had not relied on the business judgment of the Special Litigation Committee in dismissing these claims, the Court of Appeals discussed that issue.

The court first observed that the business judgment rule "as a bar to a shareholder's derivative action is inextricably linked to the requirement in a number of jurisdictions that the plaintiff-shareholder first make a demand on the directors to pursue the claim" so that "the directors are then able to determine whether in their opinion a suit on behalf of the corporation would comport with the best interests of the corporation." 582 F.2d at 274-75 (citations omitted). After reciting the policies which support both the business judgment rule and the demand requirement of Rule 23.1, the court stated, in *dictum,* that:

> "[W]hile the demand requirement . . . should be rigorously enforced, we do not think that the business judgment of the directors should be totally insulated from

judicial review. In order for the directors' judgment to merit judicial deference, that judgment must have been made in good faith and independently of any influence of those persons suspected of wrongdoing. In addition, where the shareholder contends that the directors' judgment is so unwise or unreasonable as to fall outside the permissible bounds of the directors' sound discretion, a court should, we think, be able to conduct its own analysis of the reasonableness of that business judgment. *Id.* at 275.

In a second case arising out of GTE's foreign payments difficulties, an intermediate state appellate court in New York, relying upon the Court of Appeals' decision below, reversed a grant of summary judgment in favor of GTE and ordered further discovery proceedings, stating that:

"[T]he business judgment rule should not be so rigorously applied as to cut short practically at the pleading stage an apparently legitimate inquiry into a nonfrivolous claim of wrongdoing by directors and officers on the ground that a committee of disinterested directors, acting on the advice of independent counsel, decided that the corporate interests will not be promoted by a derivative action. That is not to say that after the usual discovery and deposition stages of the action have been completed, summary judgment might not be the appropriate vehicle to terminate the action when the record shows that the disinterest of the directors was not refuted, the underlying facts were thoroughly investigated and cogent reasons existed in support of the decision of the committee." *Auerbach* v. *Bennett, supra,* 64 A.D.2d at 108, 408 N.Y.S.2d at 88.

These cases illustrate several significant ramifications of the decision of the court below. First, as we have suggested, the Court of Appeals' decision in the instant case is likely to be extended beyond the bounds of the mutual fund industry, largely because the transaction which plaintiffs here sought to attack was merely an unsuccessful investment rather than one arising from the fact that mutual funds are affiliated with their advisers, and because the presumption employed to discredit the independent quorum's decision is not logically confined to the mutual fund context. Second, and more important, in both of these decisions the courts were reluctant to adopt any type of presumption, but rather suggested that the proper approach in cases like this is to permit discovery concerning the independent directors' decision focusing on: (1) their independence; (2) their good faith; (3) the procedures they employed in reaching their decision; and (4) the reasons for their decision. The District Court herein conducted just such an inquiry, and its careful handling of the issue merits affirmance by this Court.

After affording plaintiffs extensive discovery, the District Court reached a number of factual conclusions. First, it found that the members of the independent quorum in fact acted independently. 426 F. Supp. at 849. Second, it found that the quorum's decision was made in good faith, a conclusion which the Court of Appeals expressly accepted. 426 F. Supp. at 852; *see* 404 F. Supp. at 1180. Third, the District Court discussed at some length the procedures employed by the independent quorum, including the use of independent special counsel, the series of consultations and meetings held by the members of the independent quorum in reaching their decision, the breadth of their inquiry, and the fact that both the quorum of deciding directors and Judge Fuld received full and accurate information from the defendants with regard to their inquiry. 404 F. Supp. at 1175-77. Fourth, the District Court observed that:

"[E]ven if the defendants are required as a matter of law to negate any suggestion of unfairness arising from the decision to abandon the derivative claims . . . they have done so. The exhibits presented to the court

> on both the earlier motion to dismiss and the instant motion show that the minority directors carefully evaluated the opinions tendered by both counsel involved in this action, that they considered the merits of the derivative claims asserted in the complaint, that they discussed the facts and circumstances surrounding the purchase and retention of the notes with several of the defendant directors and that they communicated extensively among themselves before reaching a decision to seek dismissal of this suit." 426 F. Supp. at 852.

In other words, the District Court's decision fully satisfied the criteria spelled out in *dicta* in *Cramer* and *Auerbach*, and the court's deference to the independent quorum's decision under the business judgment rule was thus fully justified. One error in the Court of Appeals' approach below, as we have suggested, lay in disregarding these criteria because it could not "say that, following a trial on the merits, the defendants would be found free from liability for the Fund's losses." 567 F.2d at 1210.

Even if that be so, and Judge Fuld certainly concluded otherwise, this observation would only be relevant to the decision in a case such as this if the correctness *vel non* of the reasons which the independent quorum relied upon in reaching its decision was properly an issue, and that is simply not the case. The reasons relied upon are certainly relevant, but only in the following sense: If those reasons bore no relationship whatsoever to the decision reached, that fact would of course cast doubt upon the independence and good faith of the deciding directors.[34] The District

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[34] Similarly, if the independent directors selected counsel to assist in their deliberations who was manifestly incompetent to give the kind of advice sought or who was embroiled in a conflict of interest with respect to such advice, that too would bear on resolution of the questions of independence and good faith. *See* Fogel v. Chestnutt, *supra*, 533 F.2d at 749-50; Leech & Mundheim, *supra*, 31 Bus. Law at 1822-23.

Court clearly recognized this. In rejecting plaintiffs' argument that defendant Haire (Anchor's chairman) had taken confusing and inconsistent positions with respect to whether, if this suit continued, Fundamental would have to secure a new investment adviser—one of the many factors which the independent quorum relied upon—Judge Werker stated that "[e]ven if the minority directors erred in this determination, . . . the court cannot upset their reasoned judgment without some showing that the independence of the disinterested quorum was impermissibly curtailed. The plaintiffs have not presented any such evidence." (A. 35). The relevant case law is fully in accord.

Detailed examination of the factors upon which independent directors rely in reaching a management decision is wholly inconsistent with the business judgment rule as it has been understood in this Court and in the lower federal and state courts. *See Corbus, supra,* 187 U.S. at 463; *United Copper Securities Co., supra,* 244 U.S. at 263-64; *Ashwander, supra,* 297 U.S. at 343 (Brandeis, J., concurring) ("[Stockholders] cannot secure the aid of a court to correct what appear to them to be mistakes of judgment on the part of the officers. Courts may not interfere with the management of the corporation, unless there is bad faith, disregard of the relative rights of its members, or other action seriously threatening their property rights. This rule applies whether the mistake is due to an error of fact or of law, or merely to bad business judgment. It applies, among other things, where the mistake alleged is the refusal to assert a seemingly clear cause of action, or the compromise of it"); *Pollitz* v. *Wabash Railroad Co.,* 207 N.Y. 113, 124, 100 N.E. 721, 724 (1912); *Chelrob* v. *Barrett,* 293 N.Y. 442, 460, 57 N.E.2d 825, 833 (1944); *Glassberg* v. *Boyd,* 35 Del. Ch. 293, 308, 116 A.2d 711, 720 (1955); *Puma* v. *Marriott, supra,* 283 A.2d at 696; *Issner* v. *Aldrich,* 254 F. Supp. 696, 699-700 (D. Del. 1966). Moreover, as Judge Aldrich stated in his discussion of the demand rule in *Kauffman, supra,* requiring a full-

fledged inquiry into the correctness *vel non* of the reasons underlying a business judgment by independent directors would allow a derivative plaintiff to "try the case on the merits . . . to show that he had a right to bring it." 479 F.2d at 265 (footnote omitted). Such a result is certainly unsound, if for no other reason than its impact on the workload of the federal courts.

Finally, the Second Circuit's own decision in *Tannenbaum, supra,* a leading case concerning the power of independent mutual fund directors, supports the District Court's approach herein. Although the opinion is somewhat ambiguous, the court there refused to be drawn into a discussion of specific criticisms concerning the directors' reasons for reaching a decision committed to their business judgment, 552 F.2d at 428, and held that:

> "It should be borne in mind that the question here is not whether, as a matter of hindsight, the determination of the independent directors was correct. The question is whether the decisions by these directors to forego recapture were reasonable considered at the time and under the circumstances in which they were reached.
>
> "We conclude that the *Fogel* test governing the determination of the independent directors not to recapture was satisfied in this case. There was full disclosure by the Fund's adviser as to the possibilities of recapture and the methods available to accomplish it. All material dealing with the question was placed before the independent directors and fully considered by them. They were correctly advised by counsel as to the applicable legal standards. They carefully weighed the relative advantages and disadvantages of recapture and the economic pros and cons involved. Their decision to forego recapture was a reasonable business judgment." *Id.* at 428-29 (footnote omitted).

Thus, the court in *Tannenbaum* limited its inquiry to an assessment of the kinds of things that the independent directors did in reaching their decision, rather than to the correctness of the reasons upon which they relied. As we have shown, Judge Werker met this standard, and his careful factual assessment of the independent quorum's decision is more likely to assure fairness to all of Fundamental's shareholders than is the presumption employed by the Court of Appeals.

In the concluding section of this brief we show that there is nothing in the framework of statutory and decisional law applicable to mutual funds which supports the creation of such a presumption, even if its effects could somehow be limited to the mutual fund context. Indeed, we demonstrate that the court drew precisely the *opposite* conclusion from that intended by the Investment Company Act, with the result that the opinion below places independent directors of mutual funds under a special disability in attempting to exercise the "watchdog" function expressly intended for them by Congress and confirmed by previous decisions in both the First and Second Circuits.

III.

The Court of Appeals Misconstrued Provisions of the Investment Company Act Governing the Duties of Mutual Fund Independent Directors

The decision below conflicts with prior interpretations of the Investment Company Act of 1940, 15 U.S.C. § 80a-1, *et seq.*, in both the First and Second Circuits. The interpretation which the Court of Appeals gave to the Investment Company Act is of critical importance to its decision because the framework of the Act was said to provide one basis for departing from what the court acknowledged was a "plethora" of cases upholding "the powers of boards of directors to terminate stockholder derivative suits." 567 F.2d at 1212 n. 14.[35]

On more than one occasion this Court has stated that the *only* circumstance under which it would be willing to uphold interference with the state law of corporate governance is "where federal law expressly requires [it]," *Cort* v. *Ash*, *supra*, 422 U.S. at 84; *Santa Fe Industries,*

[35] Nine such decisions, including four by this Court, were cited by the District Court. 404 F. Supp. at 1179. The court below also offered as a basis for its decision what is described as "the unique nature of the investment company and its symbiotic relationship with its investment adviser," 567 F.2d at 1212 n. 14. The link between this observation and the presumption which the court employed was never explained. Although we believe that application of the presumption cannot logically be confined to corporations which happen to be mutual funds, *see* Point II, *supra*, our position is that, assuming *arguendo* such a limitation exists, the court below erred in the conclusion it drew based on the Investment Company Act of 1940. Moreover, the court failed to examine what significance, if any, such a "symbiotic relationship" might have under controlling state law. *See* Point I, *supra*. The District Court had found the controlling law on this question to be that "absent a showing of improper motive they [the independent directors] have always been permitted to apply their business judgment to decisions involving derivative suits against the [affiliated] corporations they serve," citing *Warshaw* v. *Calhoun*, 43 Del.Ch. 148, 221 A.2d 487 (1966). *See* 426 F. Supp. at 849.

Inc. v. *Green*, *supra*, 430 U.S. at 479. This Court has never found such a situation to have occurred, and there is clearly no provision of the Investment Company Act, express or otherwise, which satisfies that test. Indeed, the Court of Appeals did precisely what *Santa Fe* directs the federal courts not to do. By sweeping aside "established state policies of corporate regulation" the decision herein would "federalize" a "substantial portion of the law of corporations" in the complete absence of anything even resembling a "clear indication of congressional intent." 430 U.S. at 479.

The statutory provisions relied upon by the court below were those sections of the Investment Company Act which require 40% of the membership of mutual fund boards of directors to be unaffiliated with the fund's investment adviser, 15 U.S.C. §§ 80a-2(a)(3) and (19), 80a-10(a), and which provide for shareholder suits challenging the level of compensation provided for in the investment advisory contract, but seeking no other relief. 15 U.S.C. § 80a-35(b).

The legislative history of the 1970 amendments to these very sections, however, reveals Congress' intention to strengthen the standards for independence of mutual fund directors not affiliated with the investment adviser through the use of a newly defined term, "interested person."[36] Indeed, the Senate Report accompanying the 1970 amendment makes plain that even with respect to the specific issue addressed by the amendments—the level of investment advisory fees set by an adviser's contract with a fund—the new statutory language "is not intended to authorize a court to substitute its business judgment for that of the mutual fund's board of directors," S.Rep. No. 91-184, 91st Cong., 1st Sess. at 33 (1969), *reprinted in* [1970] U.S. Code Cong. & Admin. News 4897, 4903. Since the legislation relied upon by the court below was plainly intended not to supplant the business judgment rule even in the area

[36] *See* Reserve Management Corp. v. Anchor Daily Income Fund, [1978] Fed. Sec. L. Rep. (CCH) ¶ 96,566 at 94374 n. 11 (S.D.N.Y. Sept. 28, 1978).

of advisory fees where fund-adviser conflicts are most severe, *a fortiori* it can supply no basis for disenfranchising directors from control in other areas. Indeed, with respect to mutual fund governance generally the Senate Report states that:

> "The section [36(b)] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary." S.Rep. No. 91-184 at 7.

Thus, far from supplying the necessary "clear indication of congressional intent" required by *Santa Fe* in order to displace state law, if anything the statutory sections relied upon by the Court of Appeals as the basis for its decision reveal a clear intent to the contrary.[37]

Even more remarkable is that another Circuit had previously found the same sections of the Investment Company Act to express Congress' intent to strengthen and enhance the exercise of independent directorial judgment, rather than to withdraw it. In *In re Kauffman Mutual Fund Actions, supra,* a decision not even cited by the court below, a mutual fund shareholder suing derivatively for his fund's benefit sought damages from the fund's investment adviser under the Investment Company and Clayton Acts for allegedly excessive advisory fees. There, as here, the shareholder claimed that the independent directors whose presence on the mutual fund board was mandated by the Investment Company Act were disqualified from exercising their business judgment as to the disposition of the proposed claims against the investment adviser because the adviser "dominated and controlled" the entire fund board. 479 F.2d at 262. The shareholder's claim that

[37] Interpretation of the federal securities laws in a manner opposite from or contrary to the intent of Congress, even by specialized agencies such as the Securities and Exchange Commission, is not unknown. *Cf.* SEC v. Sloan, 98 S.Ct. 1702, 1711-12 (1978).

demand on the directors was excused because different rules of directorial control of corporate affairs should be applied in light of the peculiarities of the Investment Company Act was emphatically rejected by the Court of Appeals for the First Circuit:

> "Nor do we think that an exception [to the demand rule] is to be made in the case of unaffiliated directors of a mutual fund on the ground that since they are expected to be sensitive to misconduct of this variety they are automatically incapacitated from performing their duties—their approval or acquiescence making them 'wrongdoers'—once a stockholder alleges a corporate injury stemming from the adviser-fund relationship. Apart from the fact that this, again, would enable a plaintiff to try his case on the merits in order to determine whether he had a right to bring it, it would be a misconception of the nature of unaffiliated directors. . . . We do not believe . . . that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from disinterested directors in any other corporate venture. . . . To the extent that they are 'watchdogs' they should be given the opportunity, not deprived of it." 479 F.2d at 266-67.[38]

We submit that the *Kauffman* court's interpretation of the Investment Company Act is the correct one. Properly read, the Act supports the conclusion reached by the First Circuit that Congress did not intend to repeal well-established limitations upon the availability of stockholder derivative actions, and that an independent mutual fund

[38] Another indication that Congress intended disinterested directors to fulfill a "watchdog" role with respect to the interested directors is its decision not to incorporate into the Investment Company Act of 1940 a provision, proposed by the Securities and Exchange Commission, that would have forced investment companies to seek court approval before settling lawsuits against "insiders." Wolf v. Barkes, 348 F.2d 994, 997 n.4 (2d Cir. 1965).

director, just as any other corporate director, should have the power to decide whether pursuit of claims against the fund investment adviser is in the fund's best interests.

Moreover, the position of the court below conflicts with prior decisions within the Second Circuit. In *Fogel* v. *Chestnutt, supra,* decided in 1975, the Second Circuit held that the determination of independent mutual fund directors that the adviser should not pursue recapture of brokerage commissions would, as a matter of Investment Company Act policy, be respected as an exercise of business judgment provided those directors received full disclosure of potential fund-adviser conflicts. Given such disclosure, the independent directors' decision would serve to defeat a later derivative suit against the adviser because the directors were "exercis[ing] the independent judgment that Congress clearly intended," 533 F.2d at 745, *quoting Moses* v. *Burgin, supra,* 455 F.2d at 377, and their decision would be upheld as "a 'reasonable business judgment.'" *Id.* at 750. Similarly, in *Tannenbaum* v. *Zeller, supra,* a 1977 decision, the Second Circuit affirmed dismissal of a mutual fund breach of fiduciary duty claim raised derivatively by a shareholder against the investment adviser for failure to recapture brokerage commissions because the independent directors had, consistent with the *Fogel* test, exercised their business judgment to forego recapture. 552 F.2d at 418-19. With respect to Congressional intent, the *Tannenbaum* Court held that:

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the [fiduciary monies sought to be recovered by the shareholder-plaintiff] from the informed discretion of the independent members of a mutual fund's board of directors." *Id.* at 417.

Therefore, at the very least, the decision below has resulted in an unsettled state of the law that is both con-

fusing to the mutual fund industry and unnecessarily disrupts the management of an important segment of our financial economy. The inevitable consequence of approval of the Court of Appeals' decision by this Court, even if that decision were confined to the mutual fund context, will be to shift both major and minor matters of mutual fund management—including, of course, the wisdom of literally thousands of investment decisions made by the funds—from the board room to the federal courtroom.

This result is surely not required by the Investment Company Act. Yet under the decision below, a single disgruntled shareholder who produces a complaint attacking some of the directors which can withstand a motion to dismiss can totally preempt the corporation's independent directors on the matter at issue, and can have the decision which he or she wishes to challenge reviewed in a plenary trial conducted in federal court. Unless this Court reverses that decision, the system of mutual fund management contemplated by Congress and previously implemented by the courts will become as anarchistic as the business judgment rule is democratic.

CONCLUSION

For the foregoing reasons, IDS respectfully prays that the judgment of the Second Circuit Court of Appeals be reversed and the case remanded for entry of judgment dismissing plaintiffs' complaint.

November 16, 1978

Respectfully submitted,

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ADDENDUM

ADDENDUM

Statutes and Rules Involved

Delaware General Corporation Law

§ 141. Board of directors; powers; etc.

(a) The business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors, except as may be otherwise provided in this chapter or in its certificate of incorporation. If any such provision is made in the certificate of incorporation, the powers and duties conferred or imposed upon the board of directors by this chapter shall be exercised or performed to such extent and by such person or persons as shall be provided in the certificate of incorporation.

(b) The board of directors of a corporation shall consist of 1 or more members. The number of directors shall be fixed by, or in the manner provided in, the bylaws, unless the certificate of incorporation fixes the number of directors, in which case a change in the number of directors shall be made only by amendment of the certificate. Directors need not be stockholders unless so required by the certificate of incorporation or the bylaws. The certificate of incorporation or bylaws may prescribe other qualifications for directors. Each director shall hold office until his successor is elected and qualified or until his earlier resignation or removal. Any director may resign at any time upon written notice to the corporation. A majority of the total number of directors shall constitute a quorum for the transaction of business unless the certificate of incorporation or the bylaws require a greater number. Unless the certificate of incorporation provides otherwise, the bylaws may provide that a number less than a majority shall constitute a quorum which in no case shall be less than $\frac{1}{3}$ of

the total number of directors except that when a board of 1 director is authorized under the provisions of this section, then 1 director shall constitute a quorum. The vote of the majority of the directors present at a meeting at which a quorum is present shall be the act of the board of directors unless the certificate of incorporation or the bylaws shall require a vote of a greater number.

• • •

§ 144. Interested directors; quorum.

(a) No contract or transaction between a corporation and 1 or more of its directors or officers, or between a corporation and any other corporation, partnership, association, or other organization in which 1 or more of its directors or officers, are directors or officers, or have a financial interest, shall be void or voidable solely for this reason, or solely because the director or officer is present at or participates in the meeting of the board or committee thereof which authorizes the contract or transaction, or solely because his or their votes are counted for such purpose, if:

(1) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the board of directors or the committee, and the board or committee in good faith authorizes the contract or transaction by the affirmative votes of a majority of the disinterested directors, even though the disinterested directors be less than a quorum; or

(2) The material facts as to his relationship or interest and as to the contract or transaction are disclosed or are known to the shareholders entitled to vote thereon, and the contract or transaction is specifically approved in good faith by vote of the shareholders; or

(3) The contract or transaction is fair as to the corporation as of the time it is authorized, approved or ratified, by the board of directors, a committee thereof, or the shareholders.

(b) Common or interested directors may be counted in determining the presence of a quorum at a meeting of the board of directors or of a committee which authorizes the contract or transaction. (8 Del. C. 1953, § 144; 56 Del. Laws, c. 50; 56 Del. Laws, c. 186, § 5; 57 Del. Laws, c. 148, § 7.)

• • •

Investment Company Act of 1940

§ 10a Affiliations or interest of directors, officers, and employees

(a) No registered investment company shall have a board of directors more than 60 percentum of the members of which are persons who are interested persons of such registered company. Aug. 22, 1940, c. 686, Title I, § 10, 54 Stat. 806; Dec. 14, 1970, Pub. L. 91-547, § 5, 84 Stat. 1416.

§ 36 Breach of fiduciary duty—Civil actions by Commission; jurisdiction; allegations; injunctive or other relief

(a) The Commission is authorized to bring an action in the proper district court of the United States, or in the United States court of any territory or other place subject to the jurisdiction of the United States, alleging that a person serving or acting in one or more of the following capacities has engaged within five years of the commencement of the action or is about to engage in any act or practice constituting a breach of fiduciary duty involving personal misconduct in respect of any registered investment company for which such person so serves or acts—

(1) as officer, director, member of an advisory board, investment adviser, or depositor; or

(2) as principal underwriter, if such registered company is an open-end company, unit investment trust, or face-amount certificate company.

If such allegations are established, the court may enjoin such persons from acting in any or all such capacities either permanently or temporarily and award such injunctive or other relief against such person as may be reasonable and appropriate in the circumstances, having due regard to the protection of investors and to the effectuation of the policies declared in section 1(b) of this title.

(b) For the purposes of this subsection, the investment adviser of a registered investment company shall be deemed to have a fiduciary duty with respect to the receipt of compensation for services, or of payments of a material nature, paid by such registered investment company, or by the security holders thereof, to such investment adviser or any affiliated person of such investment adviser. An action may be brought under this subsection by the Commission, or by a security holder of such registered investment company on behalf of such company, against such investment adviser, or any affiliated person of such investment adviser, or any other person enumerated in subsection (a) of this section who has a fiduciary duty concerning such compensation or payments, for breach of fiduciary duty in respect of such compensation or payments paid by such registered investment company or by the security holders thereof to such investment adviser or person. With respect to any such action the following provisions shall apply:

(1) It shall not be necessary to allege or prove that any defendant engaged in personal misconduct, and the plaintiff shall have the burden of proving a breach of fiduciary duty.

(2) In any such action approval by the board of directors of such investment company of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, and ratification or approval of such compensation or payments, or of contracts or other arrangements providing for such compensation or payments, by the shareholders of such investment company, shall be given such consideration by the court as is deemed appropriate under all the circumstances.

(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient.

(4) This subsection shall not apply to compensation or payments made in connection with transactions subject to section 17 of this title, or rules, regulations, or orders thereunder, or to sales loans for the acquisition of any security issued by a registered investment company.

(5) Any action pursuant to this subsection may be brought only in an appropriate district court of the United States.

(6) No finding by a court with respect to a breach of fiduciary duty under this subsection shall be made a basis (A) for a finding of a violation of this sub-

chapter for the purposes of sections 9 and 49 of this title, section 15 of the Securities Exchange Act of 1934, or section 203 of title II of this Act, or (B) for an injunction to prohibit any person from serving in any of the capacities enumerated in subsection (a) of this section. Aug. 22, 1940, c. 686, Title I, § 36, 54 Stat. 841; Dec. 14, 1970, Pub. L. 91-547, § 20, 84 Stat. 1428.

* * *

Federal Rules of Civil Procedure

Rule 23.1, Derivative Actions by Shareholders

In a derivative action brought by one or more shareholders or members to enforce a right of a corporation or of an unincorporated association, the corporation or association having failed to enforce a right which may properly be asserted by it, the complaint shall be verified and shall allege (1) that the plaintiff was a shareholder or member at the time of the transaction of which he complains or that his share or membership thereafter devolved on him by operation of law, and (2) that the action is not a collusive one to confer jurisdiction on a court of the United States which it would not otherwise have. The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort. The derivative action may not be maintained if it appears that the plaintiff does not fairly and adequately represent the interests of the shareholders or members similarly situated in enforcing the right of the corporation or association. The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

Added Feb. 28, 1966, eff. July 1, 1966.

IN THE
Supreme Court of the United States
OCTOBER TERM, 1978

No. 77-1724

HARRY G. BURKS, JR., *et al.*, *Petitioners*,

v.

HOWARD M. LASKER, *et ano.*, *Respondents.*

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

BRIEF FOR INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE

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BRIEF FOR INVESTMENT COMPANY INSTITUTE AS AMICUS CURIAE

Investment Company Institute ("ICI") files this brief, as *amicus curiae*, in support of the petitioners' prayer that the judgment of the United States Court of Appeals for the Second Circuit entered herein on January 11, 1978 be reversed.

This brief is filed with the consent of the parties herein.

INTEREST OF THE AMICUS CURIAE

ICI is the national association of open-end investment companies (mutual funds), their investment advisers and principal underwriters. ICI has 462 investment company members, with approximately seven

million shareholders. The assets of the member funds approximate $57 billion and account for over 90 percent of the total assets of the mutual fund industry. All of the mutual fund members of ICI are registered with the Securities and Exchange Commission under the Investment Company Act of 1940, as amended, 15 U.S.C. §§ 80a-1 *et seq.*

ICI is concerned that, if permitted to stand, the Court of Appeals opinion will undermine the statutory role of independent, disinterested mutual fund directors; will leave the law concerning the authority and responsibilities of such directors in a state of confusion and disarray; and will result in the needless maintenance of litigation which independent directors determine, in the good faith exercise of their business judgment, not to be in the interest of the funds whose affairs they are responsible for governing. For the reasons stated *infra,* ICI respectfully submits that the decision of the Court of Appeals below was incorrect as a matter of law and, if permitted to stand, will substantially impair the proper operations of publicly held mutual funds under applicable state and federal law—to the detriment of both the industry and the investing public at large.

OPINIONS BELOW

The opinion of the Court of Appeals (A. 39) is reported at 567 F.2d 1208.[1] The opinions of the District Court (A. 5, 22) are reported at 426 F. Supp. 844 and 404 F. Supp. 1172.

[1] "A." refers to the single appendix filed in this Court.

JURISDICTION

The judgment of the Court of Appeals was entered January 11, 1978. A petition for rehearing was denied by order entered March 9, 1978. A petition for a writ of certiorari was granted by this Court on October 2, 1978. The jurisdiction of this Court rests upon 28 U.S.C. § 1254(1).

STATUTORY PROVISIONS INVOLVED

The statutes involved in this case are the Investment Company Act of 1940, 15 U.S.C. §§ 80a-35(a), 35(b) (1970), and the Delaware General Corporation Law, 8 Del. Code §§ 141(a), 141(b)(1974).

QUESTION PRESENTED

ICI adopts by reference the question stated by petitioners:

> Are the disinterested directors of a mutual fund, who constitute a quorum and have been found to be truly disinterested and independent, incapacitated *as a matter of law* from exercising their business judgment to determine whether maintenance of a stockholders' derivative action against the investment adviser and various directors of the fund to recover from them an investment loss sustained by the fund is in the best interests of the fund and its shareholders: i.e., does the Investment Company Act of 1940 require that a stockholders' derivative action be permitted to proceed, in any and all events, even though the disinterested directors have concluded, in the good faith exercise of their business judgment, that maintenance of the derivative action is contrary to the best interests of the fund and its shareholders?

STATEMENT OF THE CASE

The pertinent facts as well as a descriptive history of the proceedings to date are set forth in the petitioners' brief.

To summarize briefly, this case was commenced by two shareholders in Fundamental Investors, Inc. ("Fundamental")—a Delaware corporation which is an open-end investment company (mutual fund) within the meaning of the Investment Company Act—purportedly as a derivative action on behalf of Fundamental. The complaint charged Fundamental's investment adviser, Anchor Corporation ("Anchor"), and all of the directors of Fundamental at the time in question, with violations of statutory and common law duties in connection with the decision in 1969 to make and retain an investment in commercial paper issued by Penn Central Transportation Company, on which payment was not made at maturity.

Following settlement of an earlier action initiated by Fundamental itself against the dealer selling the commercial paper involved—as a result of which Fundamental recovered a portion of its losses on this investment—a quorum of five disinterested directors, none of whom was a director at the time of the events complained of, undertook to consider what position Fundamental should then take regarding the derivative action. To assist in their deliberations, the disinterested directors retained as special counsel the Honorable Stanley H. Fuld, formerly Chief Judge of the State of New York.

Thereafter, based upon detailed legal and factual memoranda submitted to the Board by Judge Fuld indicating the derivative action to be without merit, and considering the disadvantageous effects of the litigation upon Fundamental (including, *inter alia*, the cost of the litigation and the disruptive effect upon the working relationship between the fund and its investment adviser) (*see* Affidavit of Leon T. Kendall, ¶ 22 (A. 69)), the disinterested directors decided unanimously that maintenance of the action would not be in the best interest of the shareholders. They determined, therefore, to seek dismissal of the derivative action.

The District Court, after carefully reviewing "the many factors which the Board considered before making its decision not to sue" (A. 19), including those outlined in the Kendall affidavit, determined that:

> "[i]f the minority directors were truly disinterested and independent the Court will not substitute its judgment for that of the Board." (A. 19-20).

The District Court then permitted discovery on the question of the directors' independence, including their relationships with the non-participating directors, to determine whether those directors who made the decision not to continue the action were in fact disinterested and independent.

Following extensive discovery on the issue of the independence of the disinterested directors, the District Court concluded that there was no evidence upon which their independence could be impugned. Accordingly, the District Court granted Fundamental's motion to dismiss.

On appeal, the Court of Appeals reversed. Although the independent directors' actions were duly authorized under the by-laws of the corporation and applicable Delaware law—and notwithstanding the impor-

tant responsibilities expressly entrusted to mutual fund independent directors by Congress in the Investment Company Act, as amended [1]—the Court of Appeals felt that it would be "asking too much of human nature" to expect that the disinterested directors would act with the necessary objectivity in these circumstances in light of the "unique nature" of investment companies in general and their "symbiotic relationship" with their investment advisers. (A. 47-48).

The record in this case contains no suggestion of bad faith or self-dealing on the part of the disinterested directors or of any of the defendants:

1. The District Court found that plaintiffs failed to adduce "*any* factual support for their conclusion that the members of the disinterested quorum acted other than independently" in reaching their determination to seek an end to the derivative action. (A. 28) (emphasis added). The Court of Appeals stated that it had "no doubt that the five minority directors acted in good faith in all that they did." (A. 48).[2]

2. The record is clear that the disinterested quorum was fully advised; its members were aware of the facts and acted with benefit of legal advice from distin-

[1] *See infra* pp. 15-17.

[2] Nor do even the allegations of the complaint charge that the defendant directors and investment adviser realized any personal gain from the fund's purchase of Penn Central commercial paper; rather, the gravamen of the action is that the defendants were remiss in their responsibilities in making, or acquiescing in, the decision to purchase Penn Central paper in light of the information about the financial condition of the company which, plaintiffs charge, might have been obtained at the time of purchase if a more thorough review of the investment had taken place.

guished special counsel in reaching their decision. The District Court found, and the Court of Appeals did not dispute, that

> "the minority directors were furnished with disinterested counsel who analyzed the legal consequences of each alternative available to the disinterested quorum. Moreover, the affidavit of the quorum chairman and the minutes of the special meetings indicate that the minority directors acted only after they had fully considered the options available to them." (A. 30).

3. In acting as they did, in part upon Judge Fuld's opinion of the invalidity of the claims asserted in the derivative action and in part upon the various substantial business considerations that further militated against maintenance of the action, the disinterested quorum clearly acted well within the parameters of reasonableness. Unless the independent directors are barred from so acting by the policies or provisions of the Investment Company Act, their determination should not be set aside by the courts. The Court of Appeals did not question the reasonableness or good faith of the independent directors' decision. Rather, the Court of Appeals ruled as a *matter of law* that disinterested mutual fund directors lack the power to terminate a "non-frivolous" shareholder derivative suit: that is, presumably, any litigation which on its face could withstand a motion for judgment on the pleadings. The Court of Appeals did not cite any specific statutory basis for its conclusion.

In these circumstances, ICI respectfully submits that the disinterested directors acted within the limits of their lawful discretion, and that the judgment of the Court of Appeals must be reversed.

ARGUMENT

I. The Decision Below Undercuts the Statutory Role for Independent Directors Established by Congress in the Investment Company Act and Will Have Significant Adverse Effects on These Directors and the Operations of the Funds They Serve

A. The Court of Appeals Decision Improperly Restricted the Role of Independent Directors

The role of disinterested mutual fund directors was first established by the Investment Company Act of 1940 and legislatively reinforced and expanded after extensive consideration by Congress in the 1970 amendments to that Act.[4] These unaffiliated directors were

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[4] While the Court of Appeals in this case relied upon its assessment of "human nature" in rejecting the role of independent directors (A. 47), Congress had, over a period of four years, fully and carefully considered that role as well as the operations and structure of the mutual fund industry when it debated and enacted the 1970 amendments to the Investment Company Act. *See, e.g.*, S. Rep. No. 91-184, 91st Cong., 1st Sess. 1 (1969) ("During the last three years, this Committee held extensive hearings and executive sessions on this subject matter. This proposed legislation was also debated at length on the Senate Floor in July 1968."); Investment Company Amendments Act of 1970, Conference Report (S. 2224), Rep. No. 91-1631, 91st Cong., 2d Sess. (1970); Investment Company Amendments Act of 1970, Report of the House Committee on Interstate and Foreign Commerce on H.R. 17333, H. Rep. No. 91-1382, 91st Cong., 2d Sess. (1970); Hearings before the Subcommittee on Commerce and Finance, House Committee on Interstate and Foreign Commerce on H.R. 11995, S. 2224, H.R. 13754 and H.R. 14737 (Mutual Fund Amendments, Parts 1 and 2), No. 91-33, 34, 91st Cong., 1st Sess. (1969); Hearings before the Senate Committee on Banking and Currency on S. 34 and S. 296, Investment Company Amendments Act of 1969, 91st Cong., 1st Sess. (April 15, 17 and 18, 1969); Investment Company Amendments of 1969, Analysis of S. 34, Senate Committee on Banking and Currency, 91st Cong., 1st Sess. (1969); Investment Company Amendments Act of 1968, Report of Senate Committee on Banking and Currency on S. 3724, S. Rep. 1351, 90th Cong., 2d Sess. (1968); Hearings before a Subcommittee of the Senate Committee on Banking and Cur-

viewed as "watchdogs" over the interests of the shareholders and charged under the statute with reviewing and approving contracts and matters in which the manager had an interest, such as the fund's management and underwriting contracts.[5] Congress viewed independent directors as providing "an independent check on management. . . ." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

On an industry basis, mutual funds make literally tens of thousands of investment decisions each year with respect to billions of dollars of assets which are managed for the benefit of millions of shareholders. Each one of these thousands of investment decisions which, with the benefit of hindsight, was a poor decision gives rise to the possibility of a derivative action in which one or more disappointed shareholders may seek to recover on behalf of the fund the full amount of the loss from the investment adviser, affiliated directors and others.

The role of independent directors, who are not defendants or otherwise personally interested in the outcome of the action, has been improperly restricted by the decision below. Congress expressly stated that the provisions of the Investment Company Act were "not intended to shift the responsibility for managing an

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rency on S. 1659, Mutual Fund Legislation of 1967, 90th Cong., 1st Sess. (July 31, August 1-4, 14-15, 1967); Investment Company Amendments of 1967, S. 1659 (Comparative Print and Analysis of S. 1659), Senate Committee on Banking and Currency, 90th Cong., 1st Sess. (1967); Report of the SEC to Congress on the Public Policy Implications of Investment Company Growth, H. Rep. 2337, House Committee on Interstate and Foreign Commerce, 89th Cong., 2d Sess. 332-35 (1966).

[5] *See infra* pp. 16-17.

investment company in the best interest of its shareholders from the directors of such company to the judiciary." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969). If the independent members of a mutual fund board of directors determine that the institution or maintenance of the claims set forth in a derivative action would not be in the interest of the fund—*e.g.*, because they determine the claims to be without merit or because of other proper considerations—they should have discretion to refuse to approve or to seek dismissal of the action. As the Securities and Exchange Commission recently stated, the independent directors should be able to exercise "their business discretion in the best interests of the fund shareholders. . . ."[6] Under the decision below, however, the disinterested directors are precluded from acting in what they believe to be the fund's best interest. They must sit back and refrain from acting so long as the claims asserted in the derivative action are not patently "frivolous."

If disinterested directors cannot exercise their independent business judgment in such circumstances, the intent of Congress that disinterested mutual fund directors exercise their business judgment to determine what actions should be taken to protect the interests of all of the shareholders will be frustrated.

For the role of the independent mutual fund director to be an effective one, it is important that individuals of ability, experience and integrity agree to accept these positions. The decision below—which wrongfully withdraws from independent directors their authority

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[6] Brief of the Securities and Exchange Commission, *Amicus Curiae* at 28, *Tannenbaum* v. *Zeller*, 552 F.2d 402 (2d Cir.), *cert. denied*, 434 U.S. 934 (1977).

to exercise their good faith business judgment in the interest of the fund and which unfairly denigrates such directors as a class by the unsupported assumption that they must be, as a matter of law, incapable of acting with objectivity—will hinder, not help, efforts to encourage responsible individuals to serve in this role. Rather than enhancing the operation of mutual funds in the interest of the vast majority of shareholders, the decision below will emasculate the role of the "independent watchdog" director that Congress selected and in 1970 reaffirmed as a "key" means of assuring that investment companies are in fact run for the benefit of their shareholders. *See, e.g., Tannenbaum* v. *Zeller,* 552 F.2d 402, 406 (2d Cir.), *cert. denied,* 434 U.S. 934 (1977).

B. The Decision Below Will Encourage and Compel the Maintenance of Litigation That Is Not in the Best Interest of Mutual Fund Shareholders

If independent mutual fund directors cannot exercise their business judgment to refuse to approve or seek dismissal of litigation they determine to be not in the best interest of the fund they serve, then ICI submits that significant undesirable results can and will occur:

First, costly and time-consuming litigation will be maintained involving claims that the independent directors of mutual funds—the persons most likely to be both knowledgeable and objective—determine to be without merit or, on balance, of such little merit as not to justify the expense and other burdens of ongoing litigation. Mutual fund investment advisers regularly make thousands of investment decisions, some of which

result in losses and could give rise to litigation. The decision below will operate to remove an existing protection against the maintenance of unsound or questionable suits of this nature, which are unlikely to be in the interests of the fund or its shareholders, on whose behalf they purport to be brought. The proliferation of such actions is neither in the public interest nor the interest of the judicial system. *See Blue Chip Stamps* v. *Manor Drug Stores,* 421 U.S. 723, 742-43 (1975).

Second, to the extent that the maintenance of such derivative suits impairs the working relationship between mutual funds and their investment advisers, a derivative action on behalf of one or two shareholders may effectively frustrate the expectation of thousands of other shareholders.[7] If litigation desired by one or two shareholders is allowed to impair the relationship between a fund and its adviser without sufficient cause, the expectations of other investors who have chosen the fund on the basis of its adviser's past performance and reputation will not be realized.

Third, the uncontrolled maintenance of the sort of claims involved in this case poses the threat of severe disruption of the operations of the mutual fund industry—particularly with respect to the activities of the funds' investment advisers.

[7] Among the considerations weighed by the disinterested directors were the possible disruptive effects of continuing the action in these circumstances; the creation of an adversary relationship between the fund and the adviser; the diversion of personnel; and the burdens imposed on the adviser. (A. 77-78). These matters, among other things, were clearly appropriate considerations for the directors to weigh.

Investment advisers to mutual funds are entrusted with the management of large amounts of assets, in exchange for which they receive compensation which is customarily calculated on the basis of a small percentage of the fund's assets. In this case, for example, the damages sought could be 200 times as great as the investment adviser's annual fees attributable to management of the assets in question.[8] The spectre of defending lawsuits brought by dissatisfied shareholders essentially seeking to make the investment adviser the guarantor of the investments selected is likely to have an adverse, disruptive effect upon the operations of the mutual fund industry.[9]

II. The Decision Below Improperly Applies the Provisions and Policies of the Investment Company Act to Reach a Result That Is in Conflict With the 1970 Amendments to That Act and With Controlling State Law

The quorum of disinterested directors, acting pursuant to the by-laws of the corporation and in accordance with Delaware law, acted within the scope of their discretionary authority in this case.

[8] Anchor's contract with Fundamental provided that Anchor would receive approximately 0.5% of the value of the assets managed as an annual fee. (Jt. App., p. 194A) ("Jt. App." refers to the Joint Appendix filed in the Court of Appeals).

[9] The issues for review in this case do not require the Court to determine whether damages could ever be recovered on this basis and, if so, in what circumstancs. ICI merely points out that the *in terrorem* effect of suits seeking damages out of all proportion to an investment adviser's income, if they may be brought at the instance of a single shareholder without any meaningful prior screening, will be substantial.

Under Delaware law, a lawfully-constituted quorum of directors is charged with managing "[t]he business and affairs of every corporation . . . except as may be otherwise provided. . . ." Delaware General Corporation Law, 8 Del. Code §§ 141(a) and (b) (1974). In discharging this broad supervisory responsibility, it is well-settled law that directors of corporations generally need not pursue every conceivable legal claim—especially "where the right of the corporation to recover is doubtful":

> "The mere fact that a corporation has a cause of action for an injury does not always make it incumbent upon it to sue, any more than in the case of an individual. If, in the opinion of the directors or a majority of the stockholders, the interests of the company do not require it to sue, it need not do so. The matter ordinarily is within their discretion, and if they act in good faith, their refusal to sue violates no right of dissenting stockholders, so as to entitle them to maintain a suit in their own behalf." 13 *Fletcher Cyc Corp. (Perm Ed)* § 5822 (1970) (footnote omitted).

See, e.g., United Cooper Securities Co. v. *Amalgamated Copper Co.*, 244 U.S. 261 (1917); *Corbus* v. *Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903); *Ash* v. *IBM*, 353 F.2d 491 (3d Cir. 1965), *cert. denied*, 384 U.S. 927 (1966); *Alleghany Corp.* v. *Kirby*, 344 F.2d 571, 573 (2d Cir. 1965), *cert. dismissed*, 384 U.S. 28 (1966); *Warshaw* v. *Calhoun*, 43 Del. Ch. 148, 221 A.2d 487 (Sup. Ct. 1966).

Moreover, if a quorum of disinterested directors is available to pass upon such matters, they are not prevented from determining to dismiss a pending action

simply because the composition of the board may have changed between either the time when the cause of action arose or the complaint was filed, or because the "interested" directors recuse themselves from the decision-making process after a shareholder derivative suit has been filed to compel prosecution of the corporation's alleged claims.[10] *See, e.g., Brody* v. *Chemical Bank*, 482 F.2d 1111, 1114 (2d Cir.), *cert. denied*, 414 U.S. 1104 (1973), *on remand*, 66 F.R.D. 87, 89 (S.D.N.Y. 1974), *aff'd* 517 F.2d 932, 934 (2d Cir. 1975); *Gall* v. *Exxon Corp.*, 418 F. Supp. 508 (S.D.N.Y. 1976); *Independent Investor Protective League* v. *Saunders*, 64 F.R.D. 564, 570-71 (E.D. Pa. 1974).

If the result below can be justified, therefore, it must be premised upon the Investment Company Act of 1940, which was enacted in part because of the special nature of the investment company industry to which the Court of Appeals referred. However, neither the statute nor its underlying policies (Section 1(b)) compel the departure from established principles indulged in by the Court of Appeals. On the contrary, they compel precisely the opposite result.

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[10] Plaintiffs in this case have raised the spectre that, in such circumstances, "[a] controlling majority of defendant directors could create a distinterested quorum after the litigation had commenced by rotating themselves out of office until a quorum perceived as friendly were available to exercise business judgment." *Respondents' Brief in Opposition to the Petition for Certiorari*, at p. 20. Any such abuses, of course, can be guarded against by permitting plaintiffs—as the District Court did in this case—full discovery with respect to the method of selection and other indicia of the actual independence of the directors who comprise the disinterested quorum.

When it amended the Investment Company Act in 1970, Congress specifically considered the problem of the influence exerted by the investment adviser over the unaffiliated directors. Congress nevertheless chose to *reject* proposals for significant structural changes in investment company governance and instead adopted additional safeguards keyed to the important role of independent directors. Specific new provisions, which were designed to assure their independence and strengthen the independent checks on management, were adopted.[11]

For example, Congress added Section 2(a)(19) defining the term "interested person" and substituted that new broader concept for the term "affiliated person" as used in Section 10, which requires at least 40 percent of each fund's board to be disinterested persons. It also amended Section 15 of the Act governing ratification of advisory (management) and underwriting contracts by the board, to require approval "by the vote of a majority of directors, who are not parties to such contract or agreement or interested persons of any such party. . . ." Congress also reinforced the statutory role of independent fund directors by amending Section 36. The Senate Report stated:

> "These provisions highlight the fact that the section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969).

[11] *See, e.g.*, Part E: Strengthening Independent Checks on Investment Company Management, S. Rep. No. 91-184, 91st Cong., 1st Sess. 32-34 (1969) (discussing amendments to Sections 2(a), 10, 15 and 32(a) adding the term "interested person").

Thus, it is clear that independent directors of mutual funds were intended by Congress to have a significant measure of authority and responsibility in the exercise of their business judgment in such sensitive areas as approval of management and underwriting contracts. There is no basis in the statute, express or implied, for precluding the exercise of such judgment by independent directors in the area of fund litigation, when the exercise of discretion is permitted—indeed mandated—in much more sensitive areas of greater consequence to the operations of mutual funds. To do so unnecessarily displaces the corporate mechanism recognized and strengthened by Congress with the viewpoint of a court, in a situation where judicial intervention is not required to safeguard the interests of shareholders.

III. The Court of Appeals Decision Represents an Unsupportable Departure From Existing Decisional Law Concerning the Role of Independent Directors Under the Investment Company Act

Prior to the decision below, no court had interpreted the Investment Company Act to restrict so narrowly the role of the independent directors as the Court of Appeals did in this case. On the contrary, the cases arising under the Act—both in the Second Circuit and in other Circuits—makes clear that the decisions below severely undercuts the purposes of the statute and, in particular, the amendments passed by Congress in 1970 for the express purpose of *expanding* the responsibilities of independent directors of mutual funds.

A. The Decision Is Inconsistent With the "Demand" Cases

Thus, in *In re Kauffman Mutual Fund Actions*, 479 F.2d 257 (1st Cir.), *cert. denied*, 414 U.S. 857 (1973), the First Circuit refused to permit a shareholder derivative action on behalf of a mutual fund, where the shareholder had not initially made a demand upon the independent directors. The court affirmed the primacy of the determinations of independent directors in the area of litigation, stating:

> "All disinterested directors must 'act honestly and according to their best judgment for the interests of all.' When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with 'full knowledge of the basis for the claim,' it is for the directors, who have 'the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure' to decide on the appropriate corporate response. To the extent that they they are 'watchdogs' they should be given the opportunity, not deprived of it." *Id.*, 479 F.2d at 266-67 (citations omitted).

As the *Kauffman* court explained:

> "We recognize the social desirability of bona fide, well founded minority suits. We also recognize the tremendous waste involved in suits that are not well founded." *Id.*, 479 F.2d at 267.

See also Moses v. *Burgin*, 445 F.2d 369 (1st Cir.), *cert. denied*, 404 U.S. 994 (1971). *Cf. Heit* v. *Baird*, 567 F.2d 1157, 1162-63 n.6 (1st Cir. 1977).

The fundamental premise of decisions requiring a demand on directors, whether or not they involve mutual funds, is that the directors of a corporation are the proper persons to pass on whether an action on behalf of the corporation should be maintained, unless plaintiffs establish the directors' bias or lack of independence. In this case, the deciding quorum of directors consisted entirely of individuals who (1) were charged with performing a particular statutory function, under the Investment Company Act, to protect the interests of all the shareholders; (2) were found by the District Court to be truly independent in fact as well as in theory; and (3) were not named as defendants or involved in any way in the litigation which they determined it would in the best interest of the fund not to pursue. The Court of Appeals' rejection of the business judgment of the disinterested quorum, in these circumstances, cannot be sustained.

B. The Decision Constitutes an Unjustified Departure From the Business Judgment Standard Expressed in *Tannenbaum* v. *Zeller*

The decision below also represents an abrupt and unjustified departure from the Second Circuit's own determination in *Tannenbaum* v. *Zeller*, *supra*, which sustained the validity of the exercise of the sound business judgment of independent directors with respect to the issue of whether mutual funds need in all circumstances seek to "recapture" brokerage commissions. There, the Court of Appeals for the Second Circuit stated:

> "We have found nothing in the structure or legislative history of the Investment Company Act which indicates that Congress meant to remove the question of how best to use the brokerage generated by portfolio transactions from the informed discretion of the independent members of a mutual fund's board of directors." *Id.*, 552 F.2d at 417.

The court in *Tannenbaum* concluded:

> "Thus the decision to forego recapture here did not violate the fiduciary obligations of either the Fund's adviser or directors under section 36 of the Investment Company Act if the independent directors (1) were not dominated or unduly influenced by the investment adviser; (2) were fully informed by the adviser and interested directors of the possibility of recapture and the alternative uses of brokerage; and (3) fully aware of this information, reached a reasonable business decision to forego recapture after a thorough review of all relevant factors." *Id.*, 552 F.2d at 418-19 (footnote omitted).

The record establishes that the three elements of the *Tannenbaum* standard were satisfied in this case. The District Court's decision clearly found (1) that the deciding directors were independent (*i.e.*, they were not "dominated" or "unduly influenced"); and (2) that they had acted only after careful and full exploration of the situation, with the advice of distinguished independent counsel (*i.e.*, they were "fully informed"). Moreover, it is clear from the opinion and the result reached that the District Court believed that the directors' determination not to continue the action in this case was well within the range of reasonable business judgment contemplated by the third element in *Tannenbaum*.[13] The District Court expressly found that the disinterested directors acted independently.

[12] ICI submits that the *Tannenbaum* decision may go too far in suggesting that the federal courts exercise plenary jurisdiction to review the "reasonableness" of lawful business decisions by corporate directors. While the facial reasonableness of a decision by the directors might be weighed by the court along with other

This finding was not disturbed by the Court of Appeals, which also found that the disinterested directors acted in "good faith."[13]

Instead, the Court of Appeals based its reversal of the District Court's decision in this case on the startling and unprecedented determination that the independent and statutorily disinterested directors of a mutual fund are incapacitated *as a matter of law* from *ever* exercising their business judgment to terminate "non-frivolous" actions against the fund's investment adviser and affiliated directors.[14]

evidence in passing upon whether the disinterested directors in fact made an independent and informed determination, no statutory or decisional basis empowers the federal courts to second guess the wisdom of directors' decisions as such. *See, e.g., Ashwander* v. *Tennessee Valley Authority*, 297 U.S. 288, 343 (1936) (Brandeis, J., concurring); *Warshaw* v. *Calhoun*, *supra*, 221 A.2d at 492-93. On the record in this case, however, it is not necessary for this Court to determine that issue, since the reasonableness of the decision of the disinterested directors could not be seriously disputed.

[13] The District Court stated:

> "The court has carefully reviewed the many factors which the Board considered before making its decision not to sue. Although plaintiffs argue that there is more merit to their claims than Judge Fuld gave them, there were many other factors considered by the directors, as outlined in the Kendall Affidavit ¶ 22—which led the directors to their decision." (A. 19).

[14] Indeed, affirmance of the District Court's decision in this case should have followed *a fortiori* from *Tannenbaum*. In *Tannenbaum*, the decision in issue—whether the fund could forego "recapture" of excess brokerage commissions—involved a determination by the disinterested directors with respect to matters in which the "interested" directors could have some personal financial interest. The conduct plaintiffs seek to challenge in this case, in contrast, does not involve any such potential conflict. There is no suggestion in the record that either the directors or the adviser benefited in any

C. The Basis for the Decision Is Not Supported by the Authorities Cited by the Court of Appeals

The Court of Appeals cited only two "authorities"—one case and one law review article—in support of the cornerstone to its decision in this case: that is, the proposition that it would be "asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues in a situation where an adverse decision would be likely to result in considerable expense and liability for the individuals concerned." (A. 47). Neither the one case nor the law review article cited by the Court of Appeals supports this assertion. (A. 47 n.13).

In *Fogel* v. *Chestnutt*, 533 F.2d 731 (2d Cir. 1975), *cert. denied*, 429 U.S. 824 (1976), the court found that there had been "inadequate communication to the independent directors" with respect to the matters in issue. 533 F.2d at 750. The court in *Fogel* did *not* say that fully informed and independent directors were incapable of responsible decision-making; it said exactly the opposite:

> "Congress . . . mandated independent directors in order 'to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.' The minimum requirement to enable the Fund's independent directors to discharge

manner from the decision to purchase Penn Central commercial paper. To the contrary, since the adviser's fee was based upon a percentage of the fund's net asset value, when an investment declined in value, the adviser also lost income.

> [their] duties . . . was a careful investigation of the possibilities performed with an eye eager to discern them rather than shut against them, and, if these possibilities were found to be real, a weighing of their legal difficulties and their economic pros and cons. It would have been still better to have the investigation of [the facts] and their legal consequences performed by disinterested councel furnished to the independent directors.
>
> "*If this had been done and the independent directors had concluded that, because of legal doubts, business considerations or both, the Fund should make no effort [to pursue the matter], we would have a different case.*" 533 F.2d at 749-50 (footnotes and citations omitted) (emphasis added).

In Nutt, *A Study of Mutual Fund Independent Directors*, 120 U. Pa. L. Rev. 179 (1971), the author merely points out that, prior to the 1970 amendments to the Investment Company Act, certain "studies of the [mutual fund] industry [had] been critical of the adviser's handpicking of new directors." *Id.* at 216. The article does not take the position that mutual fund directors can never be trusted to act independently; it expressly rejects the views of those who would espouse such unsupported generalizations:

> "Why such a pessimistic view prevails among many critics of the independent director concept is not entirely clear. . . . The 1970 Amendments' definition of 'interested persons' eliminates from independent director status anyone with a material business, professional, or personal relationship with the adviser. In addition, many independent directors are now selected by their predecessors, and may seek advice from other independents rather than advisers' personnel. *There is no reason to assume that if the independent direc-*

tors are aware of a problem area they cannot deal appropriately with it. . . . Moreover, most directors are unquestionably men of intelligence and ability who can survey material quickly and act responsibly within a short period of time." Id. at 265-66 (emphasis added).

There is simply no justification—in the statute, in its legislative history, in other pertinent cases or in public policy—for the result reached by the Court of Appeals below.

CONCLUSION

For the foregoing reasons, this Court should reverse the judgment of the Court of Appeals below, and should remand with instructions to reinstate the judgment of the District Court dismissing the complaint.

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No. 77-1724

IN THE
Supreme Court of the United States
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v.
HOWARD M. LASKER AND IRVING GOLDBERG

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE SECURITIES AND EXCHANGE COMMISSION AS AMICUS CURIAE

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QUESTION PRESENTED

Whether the Investment Company Act of 1940, 15 U.S.C. 80a-1 *et seq.*, allows a quorum of directors of an investment company to terminate a stockholders' derivative suit if they exercise independent, fully informed and reasonable business judgment.

INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

Congress has given the Securities and Exchange Commission responsibility for enforcing the federal securities laws, including the Investment Company Act of 1940. Under that Act, the Commission has "broad regulatory authority over the business prac-

tices of investment companies." *E.I. duPont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 52-55 (1977). A major purpose of the Act is to protect investment company shareholders against harm flowing from conflicts of interest between a company's shareholders and its directors and investment adviser. In light of that purpose, the Commission, like the court of appeals, is aware of the risk that the statutorily "disinterested" directors of an investment company may be tempted to disregard their fiduciary responsibility to act in the best interests of the shareholders and, instead, to act in the interests of other directors or the company's adviser. That they not do so is particularly important where, as in the present case, they take action to terminate a shareholders' derivative suit brought against other directors and the adviser under the federal securities laws, for such private suits may provide needed redress to injured investors and serve as a "necessary supplement" to the Commission's own enforcement proceedings. *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 382 (1970); *J.I. Case Co.* v. *Borak*, 377 U.S. 426, 432 (1964).

The court of appeals sought to achieve the statutory objective by holding that disinterested directors may not, under any circumstances, exercise business judgment to terminate a non-frivolous shareholders' derivative suit. But important benefits to shareholders stem from objective and informed participation by disinterested directors in the management of investment companies. The Commission is concerned that the interpretation of the court of appeals will deprive investment companies of those benefits, and will prevent disinterested directors from terminating derivative suits that are injurious to the company and its shareholders.

For the reasons explained below, we believe that the congressional goal of active stewardship by disinterested directors, performing their responsibilities in the best interests of shareholders, can be achieved by applying the traditional business judgment rule within a framework of safeguards. These safeguards would assure that, when disinterested directors take action to terminate a shareholders' derivative suit, they will exercise independent, fully informed and reasonable business judgment for the benefit of the shareholders.

STATEMENT

This derivative suit was commenced in February 1973 by respondents, two shareholders of Fundamental Investors, Inc., an investment company registered under the Investment Company Act of 1940 (the Act), 15 U.S.C. 80a-1 *et seq.* Respondents brought suit on behalf of the company against several members of its board of directors and its investment adviser. The complaint alleged that the defendants had violated their duties under the Investment Company Act,[1] the Investment Advisers Act of 1940,[2] and the common law in connection with the purchase and retention by the company of $20 million in Penn Central Transportation Company commercial paper (Pet. App. 26a).

Discovery in the derivative action was stayed for two years while the company pursued its own litigation against the dealer that had sold it the commercial paper. After it had settled that litigation, the company

[1] Section 13a-3, 15 U.S.C. 80a-13(a)(3), and former Section 36, 15 U.S.C. (1970 ed.) 80a-1(a)(35), 54 Stat. 841.

[2] Section 206, 15 U.S.C. 80b-6.

moved to dismiss the derivative action on the ground that five disinterested members of the board of directors had unanimously determined that, in their business judgment, continuation of the derivative action was contrary to the best interests of the company and its shareholders (Pet. App. 27a-28a).[3]

The district court held that, under the business judgment rule first discussed by this Court in *Hawes* v. *Oakland*, 104 U.S. 450 (1881), a quorum of the directors, if truly disinterested, has authority to terminate a derivative suit that the disinterested directors conclude is contrary to the company's best interests. The court rejected respondents' argument that the policies of the Act preclude the directors from making such a determination (Pet. App. 10a-11a, 12a, 18a).

The court permitted respondents to conduct discovery on the question of the directors' independence (Pet. App. 11a). After completion of discovery, the district court granted summary judgment against respondents, holding that they had failed to present evidence im-

[3] Of the company's 11 directors, six were either named as defendants in the derivative action or affiliated with the defendant investment adviser. The five directors who decided to terminate the derivative suit served as "disinterested" directors, which are required by Section 10 of the Act, 15 U.S.C. 80a-10. These disinterested directors were not named as defendants in the action and had not been involved in the transactions complained of (Pet. App. 4a, 27a-28a). The disinterested directors received legal counsel from Stanley Fuld, retired Chief Judge of the New York Court of Appeals (*id.* at 28a).

Under the company's certificate of incorporation and by-laws, a quorum (defined as one-third of the directors then in office, but not less than three directors) had authority to render business decisions on behalf of the company (Pet. App. 4a & n.1).

peaching the independence of the directors who voted to terminate the suit (*id.* at 18a-23a).[4]

The court of appeals reversed, relying on its interpretation of the policies of the Investment Company Act. In light of the congressional purpose to "eliminate those aspects of the conduct and administration of [mutual] funds which benefited the managers and adversely affected the stockholders," the court concluded that the statute is

> designed to interpose statutorily disinterested directors as a check on the actions of the majority directors controlled by the investment adviser. It would be contrary to the legislative purpose to permit the independent minority to be used to approve majority action so that no stockholder complaint could survive that approval.

Pet. App. 31a. The court also concluded that, as a matter of law, "[i]t is asking too much of human nature to expect that the disinterested directors will view with the necessary objectivity the actions of their colleagues" (*id.* at 32a). The court therefore found it unnecessary to consider the findings of the district court on the issue of independence. The court of appeals held that the traditional business judgment rule, applicable to other kinds of corporations, is inapplicable here because of "the unique nature of the investment company and its symbiotic relationship with its investment adviser" (*id.* at 33a n.14).

SUMMARY OF ARGUMENT

1. This case calls for the accommodation of two important policies of the Investment Company Act of

[4] Although the district court placed the burden of persuasion on respondents, it observed that even if the disinterested directors were required to prove their independence they have done so in this case (Pet. App. 22a).

1940, 15 U.S.C. 80a-1 *et seq.*, which declares that it is contrary to public policy for investment companies to be managed "in the interest of directors, officers, [or] investment advisers * * * rather than in the interest of * * * security holders." 15 U.S.C. 80a-1(b)(2). It is therefore essential that a decision by an investment company's directors to terminate a shareholders' derivative action against the directors and the company's investment adviser be examined to ensure that the decision is in the best interests of the shareholders. But Congress also has determined that the investment company's disinterested directors are to serve as "watchdogs" (*Tannenbaum* v. *Zeller*, 552 F.2d 402, 406 (2d Cir.), cert. denied, 434 U.S. 934 (1977)), and they have the primary responsibility for protecting the interests of absent shareholders. If that statutory policy is to be implemented, then a determination by such directors that a derivative action is harmful to the company should not be ignored.

The court of appeals concluded that disinterested directors should never stand in the way of a nonfrivolous derivative suit seeking to vindicate the rights of shareholders. But that approach ignores both the important statutory role to be served by disinterested directors and the possibility that the disinterested directors may be right—that the derivative suit may cause harm to the company (and thus to all shareholders) greater than any possible benefit.

The district court, in contrast, appears to have concluded that courts should accept the determination of the directors to terminate suit so long as they are "independent" of the defendants named in the complaint. That approach also is deficient, because it ignores the

possibility that the disinterested directors, by failing to consider material information or by making a decision that is not a reasonable business judgment, may not have acted in the best interests of the shareholders.

We believe that a proper interpretation of the business judgment rule should give effect to the decision of disinterested directors to terminate a nonfrivolous derivative action only where the district court finds that the directors were independent, fully informed, and acted reasonably. The district court should not dismiss a derivative complaint unless it is satisfied that each of these elements is present, for otherwise a meritorious claim against directors and the adviser may be improperly abandoned and the congressional purpose that investment companies be managed solely for the benefit of shareholders undermined.

2. Shareholder protection does not, however, require that a lawsuit continue where fully informed and independent directors reasonably determine that maintenance of the suit will injure the company. The decision of the court of appeals that disinterested directors may never terminate a derivative action is based on a failure to give proper consideration to the structure and purposes of the Act. Except for suits brought under Section 36(b), a provision not involved here, nothing in the Act deprives the directors of their traditional authority to terminate derivative actions that are harmful to the company. Indeed, Congress has stated that the Act did not intend "to ignore concepts developed by the courts as to the authority and responsibility of directors." S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969). Moreover, Congress has determined that the disinterested directors are to serve as watch-

dogs, and "[t]o the extent that they are 'watchdogs,' they should be given the opportunity, not deprived of it." *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 267 (1st Cir.), cert. denied, 414 U.S. 857 (1973).

3. The district court declined to review the reasonableness of the decision of the disinterested directors to abandon this litigation. The failure of the district court to review reasonableness is particularly troublesome because this is a case where "many millions of dollars" are potentially at stake (Pet. App. 32a) and a colorable claim has been asserted. We suggest that the case be remanded for the district court to examine the grounds underlying the conclusion of the disinterested directors that the burdens of the litigation outweigh its benefits. This review does not permit the district court to substitute its views for those of the directors or to hear the case on the merits. Because, however, Congress has determined that management must act in the interest of shareholders, the suit should not be dismissed unless the district court finds that the decision of the directors was a reasonable exercise of business judgment.

ARGUMENT

IN LIGHT OF THE STATUTORY PURPOSE TO PROTECT SHAREHOLDERS AGAINST CONFLICTS OF INTEREST AND BREACHES OF FIDUCIARY DUTY BY INVESTMENT COMPANY MANAGERS, AN INVESTMENT COMPANY'S DISINTERESTED DIRECTORS MAY TERMINATE A DERIVATIVE SUIT AGAINST OTHER DIRECTORS AND THE COMPANY'S INVESTMENT ADVISER ONLY IF THEIR DECISION IS AN INDEPENDENT, FULLY INFORMED, AND REASONABLE BUSINESS JUDGMENT

The decision of the court of appeals reflects its concern that the disinterested directors of an investment company are not capable of evaluating objectively the

desirability of maintaining a derivative action against their fellow directors and the company's adviser. Although the court was appropriately concerned about shareholder protection, we believe that shareholder protection can best be achieved by applying certain safeguards to the traditional business judgment rule. The business judgment rule, as defined by this Court, is itself a rule of shareholder protection and should not lightly be discarded. See, *e.g.*, *Corbus* v. *Gold Mining Co.*, 187 U.S. 455, 463 (1903):

> The directors may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right. They may regard the expense of enforcing the right or the furtherance of the general business of the corporation in determining whether to waive or insist upon the right. And a court of equity may not be called upon at the appeal of any single stockholder to compel the directors or the corporation to enforce every right which it may possess, irrespective of other considerations.

Although we disagree with the court of appeals' conclusion that the Investment Company Act deprives directors of all authority to terminate derivative litigation, we believe that the Act requires that the business judgment rule be applied in a manner that is consistent with the statutory purpose of protecting shareholders against conflicts of interest and breaches of fiduciary duty. That purpose will be served if the business judgment rule is applied in cases where the directors are truly independent, are fully informed of the material facts, and render a business judgment that is reasonable under all the circumstances.

A. The Investment Company Act Was Intended to Regulate Conflicts of Interest and Prohibit Breaches of Fiduciary Duty by Investment Company Directors and Advisers

An investment company is a pool of liquid assets owned by its shareholders. An investment company of the kind involved in this case (a mutual fund) usually is controlled by its investment adviser, an entity that often has its own shareholders. The adviser typically organizes and promotes the mutual fund, provides management services, selects the fund's investments, handles sales of the fund's shares through an affiliated underwriter, and supervises the business operations of the fund. Persons affiliated with the adviser usually serve on the board of directors of the investment company. See generally *Tannenbaum* v. *Zeller*, 552 F.2d 402, 405-406 (2d Cir.), cert. denied, 434 U.S. 934 (1977).[5]

The Investment Company Act of 1940 is an outgrowth of congressional concern that existing federal and state law was inadequate to protect the owners of investment company shares. In its *Report on the Study of Investment Trusts and Investment Companies*, H.R. Doc. No. 136, 77th Cong. 1st Sess., pt. 3, 2485-2805 (1939), the Commission identified certain pervasive abuses in the industry that called for corrective legislation. These included self-dealing, larceny, and embezzle-

[5] Ordinary business corporations are managed by officers employed directly by the corporation. The adviser of an investment company exercises at least as much control over the fund as internal management in a typical business corporation. This method of organization causes special problems, however; although the primary goal of management should be to maximize the profits of the corporation, the adviser of a mutual fund also is motivated by a desire to maximize its own profits, giving rise to potential conflicts of interest. See *Tannenbaum* v. *Zeller*, *supra*, 552 F.2d at 405.

ment by mutual fund managers. In short, "the fiduciary concepts historically applicable to the management of funds of others [had] not always been observed." *Id.* at 2486. Based on this experience, Congress concluded that the public interest was adversely affected when investment companies were managed "in the interest of directors, officers, [or] investment advisers * * * rather than in the interest of * * * security holders," and it enacted the Investment Company Act of 1940 "to mitigate and, so far as feasible, to eliminate" such abuses. See Section 1(b) of the Act, 15 U.S.C. 80a-1 (b).

As this Court has recognized, Congress intended the Act to be a pervasive regulatory scheme, imposing necessary controls on company management. See *United States* v. *National Association of Securities Dealers, Inc.*, 422 U.S. 694, 704-705 n.13 (1975).[6] Just as "Congress intended the Investment Advisers Act to establish federal fiduciary standards for investment advisers," *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 471 n.11 (1977), it likewise intended the Investment Company Act to establish federal standards for the directors and officers of investment companies.[7] In enacting the Investment Company Act, Congress declared that the activities of such companies, extending over many states, "make difficult, if not impossible, effective State regulation of such companies in the in-

[6] Questions of internal management usually left to state law, including director qualifications, requirements for the composition of the board, and limitations on the capital structure and dividend policies of the company, are comprehensively regulated by the Act. *Ibid.*

[7] The Investment Company Act and the Investment Advisers Act were enacted as Titles I and II of the same statute.

terest of investors." Section 1(a)(5), 15 U.S.C. 80a-1 (a)(5).[8]

Fundamental to the system of shareholder protection envisoned by Congress is Section 10 of the Act, 15 U.S.C. 80a-10, which governs the composition of the investment company's board of directors. As originally enacted in 1940, Section 10 required that at least 40 percent of the directors not be officers or employees of the company or affiliates of its adviser. 54 Stat. 806. Congress conceived of these unaffiliated directors as "watchdogs" (*Tannenbaum* v. *Zeller*, *supra*, 552 F.2d at 406) necessary to "furnish an independent check upon the management" of investment companies. Hearings on H.R. 10065 *Before a Subcommittee of the House Committee on Interstate and Foreign Commerce*, 76th Cong., 3d Sess. 109 (1940).[9]

After passage of the Act, the mutual fund industry grew dramatically.[10] That growth brought with it renewed concern regarding conflicts of interest and shareholder protection. The Wharton Report, *A Study of Mutual Funds*, submitted to Congress by the Commission, H.R. Rep. No. 2274, 87th Cong., 2d Sess. 34-35, 64 (1962), found serious deficiencies in the performance of unaffiliated directors in protecting the

[8] See also 86 Cong. Rec. 2844 (1940) (remarks of Sen. Wagner).

[9] Another provision enacted to regulate conflicts of interest is Section 17, 15 U.S.C. 80a-17, which forbids certain self-dealing transactions without prior approval by the Commission. See *E. I. du Pont de Nemours & Co.* v. *Collins*, 432 U.S. 46, 53-54 (1977).

[10] In 1940 the investment company industry had assets of approximately $2 billion, with mutual funds having assets of less than $450 million. By 1967 the industry's assets exceeded $50 billion, of which $45 billion were held by mutual funds. *Hearings on H.R. 9510 Before the Subcommittee of the Committee on Interstate and Foreign Commerce*, 90th Cong., 1st Sess. 27-28 (1967).

interests of shareholders. That study was followed by the Commission's *Report on Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, 89th Cong., 2d Sess. 30-31, 65-72, 135-149 (1966), which identified serious continuing problems with respect to advisory fees, sales compensation and brokerage practices.

At the recommendation of the Commission, Congress amended the Act in 1970 to strengthen the independence of the "watchdog" directors. Section 2(a)(19) of the Act, 15 U.S.C. 80a-2(a)(19), defines the new term "interested person" to include anyone who has a close relationship with the investment adviser or its affiliates through employment, stock ownership, substantial business or professional relationships, blood or marriage. In Section 10 this new term was substituted for the narrower term "affiliated person" so that at least 40 percent of the board of directors of the investment company must be composed of persons who are not "interested" within the new definition.

Congress also strengthened the fiduciary duty standards imposed under the Act. The Act now authorizes redress for "breach of fiduciary duty involving personal misconduct" (Section 36(a), 15 U.S.C. (1970 ed.) 80a-35(a)) whereas until 1970 it applied only to "gross misconduct or gross abuse of trust." 54 Stat. 841. The new standard permits courts "to deal flexibly and adequately with wrongdoing by certain affiliated persons of investment companies." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 36-37 (1970). And under the new Section 36(b), 15 U.S.C. (1970 ed.) 80a-35(b), the investment company adviser has a "fiduciary duty with respect to the receipt of compensation for ser-

vices," and the Commission and shareholders have a cause of action in federal court to contest compensation deemed to be excessive.[11]

The continuing concern of Congress, reflected in the Investment Company Act, has been protection of shareholders against conflicts of interest and breaches of fiduciary duty by directors and advisers. As we discuss below, this policy has a direct bearing on the proper application of the business judgment rule in derivative actions of this kind.

B. A Decision by Disinterested Directors to Terminate a Derivative Suit Must Comply with Standards of Fiduciary Duty Required by the Investment Company Act

In light of the fiduciary obligations imposed by Section 36(a), 15 U.S.C. (1970 ed.) 80a-35(a), and the congressional intent that disinterested directors serve as an "independent check on management," we believe that the Act should be interpreted to require that a decision to terminate a derivative suit against the company's directors and adviser meet certain minimum standards. We submit that the decision to terminate the suit should be given effect only if:

(1) The decision of the disinterested directors is in fact independent and not influenced by the interested directors or the fund's adviser.

[11] Congress also amended Section 15(c), 15 U.S.C. 80a-15(c), which governs the approval of advisory and underwriting contracts between the company and its adviser and principal underwriter. The amended provision requires approval of these contracts by the disinterested directors, requires attendance of the disinterested directors at meetings where votes are taken on such contracts and requires investment advisers to furnish directors with all information reasonably necessary to evaluate the adviser's contract.

(2) The decision of the disinterested directors is based on a consideration of all material facts relevant to the decision.

(3) The decision is reasonably based on the conclusion that the benefits to the company resulting from the suit are outweighed by the disadvantages.

This three-part test was discussed and adopted by the Second Circuit in *Tannenbaum* v. *Zeller*, *supra*, a case dealing with the discretion of directors under the Investment Company Act to establish brokerage practices for the fund. Although we agree with the *Tannenbaum* court that these rules are called for by the policies of the Investment Company Act, they also have many antecedents in the common law.

This Court recognized long ago that a decision of a company's directors to terminate a derivative action would not be given effect if the directors were dominated or influenced by the alleged wrongdoers or subject to a conflict of interest. See, *e.g.*, *United Copper Co.* v. *Amalgamated Copper Co.*, 244 U.S. 261, 264 (1917); *Delaware & Hudson Co.* v. *Albany & Susquehanna Co.*, 213 U.S. 435, 451-453 (1909). See also Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 193-194 (1976). This Court also has recognized the importance of bringing material information to the attention of the directors; it has required the derivative plaintiff to make a specific demand on the directors and to allow them to give careful consideration to the information presented. See, *e.g.*, *Hawes* v. *Oakland*, 104 U.S. 450, 461 (1881). See also *In re Kauffman Mutual Fund Actions*, 479 F.2d 257, 266-267 (1st Cir.), cert. denied, 414 U.S. 857 (1973); *Halprin* v.

Babbitt, 303 F.2d 138, 141 (1st Cir. 1962). Finally, this Court has recognized that the directors may not terminate a derivative action if their decision constitutes a breach of duty. See, *e.g.*, *Hill* v. *Wallace*, 259 U.S. 44, 61 (1922); *Ashwander* v. *TVA*, 297 U.S. 288, 319-320 (1936); *United Copper Co.* v. *Amalgamated Copper Co.*, *supra*. See also Note, *Demand in Derivative Suits*, 73 Harv. L. Rev. 746, 759-760 (1960); Comment, *supra*, 44 U. Chi. L. Rev. at 195-196.

These common law principles reinforce the principles of the Act, and they lead inescapably to the requirements that we discuss below.[12]

1. The directors must be independent and able to exercise unbiased judgment on behalf of the shareholders

The independence requirement assures that the directors making the decision to terminate the derivative suit are in a position to carry out their fiduciary responsibilities in the best interests of the shareholders. Because the pleadings usually are insufficient to permit a court reliably to determine whether particular directors in fact are independent, it is appropriate for a court to allow limited discovery on this issue, as the district court did in the present case. See *Gall* v. *Exxon*, 418 F. Supp. 508, 519-520 (S.D.N.Y. 1976); *Bernstein* v. *Mediobanca Banca di Credito Finanziario-Societa Per Azioni*, 69 F.R.D. 592, 598 (S.D.N.Y. 1974); Comment, 44 U. Chi. L. Rev., *supra*, at 198-200. The court should carefully scrutinize the facts to assure the actual independence of the decision-makers from those parties charged as wrongdoers in the derivative complaint.

[12] Because the claims in the present case are based on federal law, the policies of federal law are significant in interpreting the judge-made business judgment doctrine. See *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 380-385 (1970); cf. *Blue Chip Stamps* v. *Manor Drug Stores*, 421 U.S. 723, 749 (1975). The common law, interpreted "remedially," "reinforces" the analysis (*SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963)).

The fact that the interested directors who are defendants in the action constitute a majority of the board is a relevant consideration in determining whether the disinterested directors have acted objectively. The concern of the court of appeals—that directors may be disinclined to permit suit against their colleagues despite their "watchdog" status (see Pet. App. 32a-33a)—is legitimate, and it calls for close attention to the independence issue. Cf. *In re Kauffman Mutual Fund Actions*, *supra*, 479 F.2d at 268-269 (Coffin, J., concurring). Indeed, we believe that it calls for placing on the parties seeking termination the burden of proof to establish independence. Particularly where, as here, a majority of the board of directors are defendants named in the complaint, and the disinterested directors are nominated to serve as directors by that same majority, a potential conflict of interest exists that justifies placing the burden of proof with respect to the issue of independence on the parties seeking termination. See, *e.g.*, *Pepper* v. *Litton*, 308 U.S. 295, 306 (1939); *Geddes* v. *Anaconda Copper Mining Co.*, 254 U.S. 590, 599 (1921). The disinterested directors should be required to show that their judgment was in fact independent.

2. The disinterested directors must be fully informed of the facts relevant to their decision

The district court also should inquire whether the disinterested directors were informed of the facts relevant to their decision. The court should be satisfied that there has been full disclosure of all relevant facts to the disinterested directors by the interested directors and the adviser. The Commission set forth the basic requirement of disclosure to unaffiliated directors in *Imperial Financial Services, Inc.*, CCH Fed. Sec. L. Rep. ¶ 77,287, at 82,464 [1964-1966 Transfer Binder]:

> The Investment Company Act's requirement as to unaffiliated directors, if its purposes are not to be subverted, carries with it the obligation on the part of the affiliated directors, and the investment adviser, to insure that unaffiliated directors are furnished with sufficient information so as to enable them to participate effectively in the management of the investment company.

Moses v. *Burgin*, 445 F.2d 369, 376-377 (1st Cir.), cert. denied, 404 U.S. 994 (1971), held that the Act imposes on the adviser and the interested directors a duty of full disclosure, explaining: "If management does not keep these [unaffiliated] directors informed, they will not be in a position to exercise the independent judgment that Congress clearly intended." See also *Tannenbaum* v. *Zeller, supra*, 552 F.2d at 407, 417-418, 426-427; *Fogel* v. *Chestnutt*, 533 F.2d 731, 749-750 (2d Cir. 1975), cert. denied, 429 U.S. 824 (1976).

Information so disclosed must, of course, be considered by the disinterested directors with the high degree of care that its importance requires.[13] See *Tannenbaum* v. *Zeller, supra*, 552 F.2d at 418-419; *Brown* v. *Bullock*, 294 F.2d 415, 421-422 (2d Cir. 1961).[14]

[13] It has long been held that directors of banks, life insurance companies, and similar financial institutions, are under an especially high standard of fiduciary care toward the money they manage. See, *e.g.*, *Goodwin* v. *Simpson*, 292 Mass. 148, 197 N.E. 628 (1935); *O'Connor* v. *First National Investors' Corp.*, 163 Va. 908, 177 S.E. 852 (1935); *Hun* v. *Cary*, 82 N.Y. 65, 71 (1880). The standard of care here should be no less.

3. The decision must constitute a reasonable exercise of business judgment

Because the statutory purpose of the disinterested directors is to protect the interests of absent shareholders in accordance with the fiduciary standards of Section 36(a), the district court should review the reasonableness of their decision to terminate the suit.[15] See *Hill* v. *Wallace, supra*, 259 U.S. at 61; *Ashwander* v. *TVA, supra*, 297 U.S. at 319-320; Comment, *The Demand and Standing Requirements in Stockholder Derivative Actions, supra*, at 196. The test

> is not whether, as a matter of hindsight, the determination of the independent directors was correct. The question is whether the decisions * * * were reasonable under the circumstances in which they were reached.

Tannenbaum v. *Zeller, supra*, 552 F.2d at 428. The factors weighed by the directors and the basis for giving weight to each of them should be reviewed to determine whether there is a reasonable basis for con-

[14] The practice of obtaining special outside counsel to assist the directors in analyzing the information presented is an appropriate one. *Tannenbaum* v. *Zeller, supra*, 552 F.2d at 428.

[15] The district court serves a similar role in derivative litigation by reviewing the reasonableness of any settlement that would terminate the suit. See 3B J. Moore, *Federal Practice* ¶ 23.1.24[2] at 23.1-137 to 23.1-139 (1976 ed.).

cluding that the disadvantages resulting from the suit outweigh the advantages.[16]

C. The Investment Company Act Does Not Divest Directors of All Authority To Terminate Derivative Litigation

The court of appeals held that the policies of the Investment Company Act preclude disinterested directors from exercising their business judgment under any circumstances to terminate a derivative action of this kind. We believe that the court's conclusion is based on a failure to give proper consideration to the structure and purposes of the Act.

1. The court of appeals appears to have relied on the fact that the Act does not specifically grant the disinterested directors authority to terminate ongoing derivative litigation. But the Act does not purport to withdraw such powers either, and it does not set out every duty and power of such directors. When Congress intended to eliminate the authority of the company's directors under the Act, it did so expressly. For example, Section 17, 15 U.S.C. 80a-17, expressly removed the authority of the disinterested directors to approve certain self-dealing transactions, and Section 36(b), 15 U.S.C. (1970 ed.) 80a-35(b), authorized shareholder actions to challenge the fairness of compen-

[16] The district court might appropriately review the director's judgment under the standards used for review of federal administrative action: courts scrutinize the record for a reasoned determination but do not substitute their judgment for that of the agency. See *United States* v. *Florida East Coast Ry.*, 410 U.S. 224 (1973); *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 416 (1971).

sation agreements between the fund and its adviser regardless of the views of the directors.[17]

Although Congress could have prohibited the disinterested directors from exercising business judgment in the circumstances of this case, it did not do so. Indeed, the Senate Report on the 1970 amendments, in discussing Section 36(b), stresses that Congress did not intend the legislation to strip the directors of their traditional business discretion:

> [T]he section is not designed to ignore concepts developed by the courts as to the authority and responsibility of directors. * * * [It] is not intended to shift the responsibility for managing an investment company in the best interest of its shareholders from the directors of such company to the judiciary.

S. Rep. No. 91-184, 91st Cong., 1st Sess. 7 (1969). Thus, there is nothing in the language of the Act or its history that requires the result reached by the court of appeals.

2. In nullifying the discretion of the disinterested directors in this case, the court of appeals also may have overlooked the choice of Congress to rely on such directors to serve as watchdogs for the benefit of absent shareholders. Congress selected the independent director requirement instead of more drastic remedies such as complete internalization of management or disaffiliation of the company from its adviser. The Commission emphasized to Congress in 1966 that "unaffiliated directors * * * can and should play an active role in rep-

[17] See also Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), which authorizes shareholder suits to recover insider "short swing" profits on behalf of the company notwithstanding the decision of the board of directors not to sue (*Benisch* v. *Cameron*, 81 F. Supp. 882, 884 (S.D.N.Y. 1948)).

resenting the interests of shareholders not only in connection with management compensation but in other areas where the interests of the professional managers may not coincide with those of the company and its public investors. Strengthening the voice of truly disinterested directors in investment company affairs is important to the protection of public shareholders." *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H.R. Rep. No. 2337, *supra*, at 147-148 (1966); (footnote omitted). The premise of the court of appeals—that disinterested directors are incapable of acting independently for the benefit of shareholders—conflicts with the congressional determination in 1970 that such directors are to "supply an independent check on management and to provide a means for the representation of shareholder interests." H.R. Rep. No. 91-1382, 91st Cong., 2d Sess. 13 (1970).

3. We also believe that the court of appeals did not fully consider the fact that the business judgment rule —applied within the guidelines discussed at pages 14-20, *supra*—is itself an important shareholder protection device. Some suits may cost more than they are worth. If the directors properly determine that the suit is injurious to the company, then shareholder protection does not require that it continue. See *Hawes* v. *Oakland, supra*, 104 U.S. at 457-462; *Corbus* v. *Gold Mining Co., supra*, 187 U.S. at 463; *United Copper Co.* v. *Amalgamated Copper Co., supra*, 244 U.S. at 263-264; *Ashwander* v. *TVA, supra*, 297 U.S. at 343 (Brandeis, J., concurring); *Swanson* v. *Traer*, 354 U.S. 114, 116-117 (1957).

This principle applies to investment companies, which may have thousands of shareholders with diverse opinions about the advisability of pursuing litigation

against a variety of defendants. See *In re Kauffman Mutual Fund Actions, supra*, 479 F.2d at 266-267:

> Normally self-dealing by any corporate director is suspect. Congress recognized, however, that a certain type of self-dealing is endemic in a mutual fund, and must be permitted. In order to make sure that the directorate not be top-heavy, it provided for a minimum number of directors who would not be so interested. We do not believe it should follow from this that, as directors required to be disinterested in a particular transaction, they differ in their fiduciary obligations from disinterested directors in any other corporate venture. All disinterested directors must "act honestly and according to their best judgment for the interests of all." * * * When corporate action, or inaction, is subsequently challenged, their duty is not extinguished, but, rather, refocused. After a demand provides them with "full knowledge" of the basis for the claim * * * it is for the directors, who have "the advantage of familiarity with the enterprise, with those who have conducted it and with the record of success or failure" to decide on the appropriate corporate response. * * * To the extent that they are "watchdogs" they should be given the opportunity, not deprived of it.

4. Although we therefore disagree with the court of appeals, and agree with the district court, about the availability of the business judgment rule in derivative suits of this kind, we do not believe that the district court applied the rule correctly.

We do not question the district court's finding that the disinterested directors were in fact independent (Pet. App. 18a-23a). And, although the district court did not explicitly consider the question whether the disinterested directors were adequately informed of the material facts, it is clear from the district court's dis-

cussion that the directors were informed and duly considered the relevant information.

The district court's failure to review the reasonableness of the decision of the disinterested directors is more troublesome, particularly because the stakes of the case are quite large [18] and it is asserted that the defendants made no "independent investigation of Penn Central's financial situation before the fund's purchase of the notes" (Pet. App. 26a).[19] The district court nevertheless declined to consider the reasonableness of the directors' conclusion that respondents' claim of breach of fiduciary duty is feeble, and it also appeared to accept at face value the directors' conclusion that disruption and expense resulting from the litigation outweighed any possible recovery (Pet. App. 5a-6a, 11a).

We therefore suggest that the case be remanded so that the district court may consider the reasonableness of the directors' decision to abandon the suit. Although we do not believe that the district court should substitute its judgment for that of the directors, a review of the reasonableness of the directors' views about the relative advantages [20] and disadvantages of the litiga-

[18] See Pet. App. 32a. The complaint in this case alleged investment losses of $20,000,000. Of this amount, $5,250,000 in cash and an interest in the potential proceeds of the Penn Central reorganization proceedings were recovered through settlement of the claim against the commercial paper dealer. A. 41

[19] During the period that the Penn Central commercial paper was held in the investment company's portfolio, the financial losses of Penn Central, which led to bankruptcy in June 1970, were "widely reported in the financial press." See *University Hill Foundation* v. *Goldman Sachs & Co.*, 422 F. Supp. 879, 889-890 (S.D.N.Y. 1976). See also Pet. App. 26a; A. 97, A. 100, A. 102.

[20] An assessment of the advantages of the litigation necessarily must include an assessment of the probable merit of the claim, for that strongly influences the expected benefits of pressing the suit.

tion, based on the information before them at the time of their decision, would not involve the court in such a substitution.[21]

CONCLUSION

The judgment of the court of appeals should be reversed and the case remanded to the district court for further proceedings.

Respectfully submitted.

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[21] Although we suggest a remand, this Court could determine reasonableness if it wishes, because that determination involves only the application of a legal standard to a documentary record.